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# Real Estate Matters

Fourth Edition

**Cutoff Dates:**

Legal editing of this book was completed July 2012.

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**Printed in California**

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# Introduction

**Real Estate Matters** is written for real estate licensees, attorneys and investors. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool.

The material in **Real Estate Matters** is a collection of various brokerage topics compiled from **first tuesday's** extensive library of real estate courses, all of which were written to update the reader about ongoing issues that affect California real estate transactions. Each chapter covers a topic of concern to both brokers and agents including notes and trust deeds, buyer's contracts and contingencies, disclosure requirements, current real estate economics property, management situations as well as tax and legal aspects.

All of this material is based on current California law and controlling federal law. **Real Estate Matters** was created to enhance the reader's understanding of a wide variety of real estate topics in order to increase the efficiency and profitability of their real estate transactions.

Included at the beginning of each chapter is a summary of the topics covered within the chapter as well as a list of key terms essential to the reader's comprehension of the issues discussed. The first instance of a key term in each chapter will appear in *italics*, with the subsequent reference to the term appearing in **bold**. Although bolded words denote a subsequent reference to a key term, bold typeface is also used for emphasis where the editors have deemed appropriate.

Unless a form cited in the book says, "See Form XXX *accompanying this chapter*" [emphasis added], it is not in the book. Unless the form accompanies the chapter, it is not crucial to your understanding of the material.

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# Licensee Conduct

# Chapter 1 The seller's agent and a prospective buyer

*This chapter distinguishes a seller's agent's limited, nonfiduciary general duty owed to all prospective buyers from a buyer's agent's special fiduciary agency duties owed to their buyers.*

### *Chapter 1 Outline*



### *Chapter 1 Terms*

| | |
|---|---|
| *Adverse facts* | *Mandatory visual inspection* |
| *Dumb agent rule* | *Prior to acceptance* |
| *Duty of care* | *Response to an inquiry* |
| *General duty* | *Title condition* |
| *Listing agent* | |

## General duty to voluntarily disclose

A listing broker and his agents have a special fiduciary agency duty, owed solely to a seller who has employed the broker, to diligently market the listed property for sale. The objective of this employment is to locate a prospective buyer who is ready, willing and able to acquire the property on the listed terms.

On locating a prospective buyer, either directly or through a buyer's agent, the seller's agent, also called a *seller's agent*, owes the prospective buyer, and thus also the buyer's agent, a limited, non-client *general duty* to voluntarily provide information on the listed property, called disclosures.

What is limited about the duty is not the extent or detail to which the seller's agent may go to provide information, but the **minimal quantity of fundamental information** and data about the listed property which must be handed to the prospective buyer or the buyer's agent.

The information disclosed by the seller's agent need only be sufficient enough in its content to place the buyer on notice of facts which may have an adverse effect on the property's value or the buyer's use.

Thus, the disclosure obligations of the seller's agent to voluntarily inform prospective buyers about the fundamentals of the listed property act to limit the seller's agent's ability to engage in any conduct or means at hand to exploit the prospective buyer. The seller's agent may not:

- deliver up less than the minimum level of information to put the buyer on notice of the property's fundamentals;
- give unfounded opinions or deceptive responses in response to inquiries; or
- stifle inquires about the property while in the vigorous pursuit of the best financial advantage obtainable for the seller.

**Gathering facts on adverse features**

The methods for gathering *adverse facts* about the property's fundamental characteristics, as well as those facts which enhance value, which the seller's agent is specifically required to disclose on the sale of a one-to-four unit residential property, include:

- conducting a **visual inspection** of the property to observe conditions which might adversely affect the market value of the property and to enter any observations of adverse conditions on the seller's Condition of Property (Transfer) Disclosure Statement (TDS) — if not already noted on the TDS by the seller or if inconsistent with the seller's disclosures, regardless of whether a home inspector's report has been or will be obtained by the seller [Calif. Civil Code §2079];
- assuring seller compliance with the **seller's duty** to deliver statements to prospective buyers as soon as possible, i.e., disclosing a variety of routine facts about natural hazards (NHD), the condition of the property (TDS), environment hazards (TDS), Mello-Roos liens, lead-based paint, neighborhood industrial zoning, occupancy and retrofit ordinances, military ordnance locations, condo documents, etc., by providing the seller with statutory forms at the listing stage to be filled out, signed by the seller, and returned to the agent for inclusion in the marketing package to be handed to prospective buyers;
- reviewing and confirming, without further investigation or verification by the seller's agent, that all the information and data in the disclosure documents received from the seller are consistent with the seller's agent's knowledge about the information and data, and if not, correct the information and data, and if the seller's agent has reason to believe

information might not be accurate, either investigate and clarify the information or disclose his uncertainty about the information to the seller and the prospective buyer in the documents;

- advising the seller on **risk avoidance procedures** by recommending the seller obtain third-party inspections of the property's condition and its components (roof, plumbing, septic, water, etc.), to **reduce the exposure** to claims by a buyer who might discover deficiencies in the property not known to the seller or the seller's agent or worse, they were known and not disclosed *prior to acceptance* of a purchase agreement, and on discovery make a demand on the seller (and the broker) to correct the defects or reimburse the buyer for the costs incurred to correct them; and

- responding to inquiries by the prospective buyer or buyer's agent into conditions relating to any aspect of the property with a full and fair answer of related facts known to the seller's agent which are or might be considered detrimental to the value of the property and does so without suppressing further investigation or inquiry by the buyer or the buyer's agent since the inquiry itself makes the subject matter a material fact about which the prospective buyer may want more information before completing negotiations or acquiring the property.

### The pass-through of filtered information

A seller's agent's statutory duty owed to prospective buyers to disclose facts about the integrity of the physical condition of a listed one-to-four unit residential property is limited to his prior knowledge about the property and the observations he made while conducting his *mandatory visual inspection*. To complete the disclosure process, the seller's agent serves as a conduit through which property information provided by the seller is filtered before the seller's agent passes it on to the prospective buyer.

Accordingly, all property information received from the seller must be reviewed by the seller's agent for any inaccuracies or untruthful statements known or suspected to exist by the seller's agent. Corrections or contrary statements by the seller's agent necessary to set the information straight must be included in the document or the document corrected before the information may be used to market the property and induce prospective buyers to purchase.

The extent to which disclosures about the physical condition of the property must be made is best demonstrated by what the seller's agent is **not obligated to provide**. All else adversely affecting value and known to the seller's agent must be brought to the attention of prospective buyers.

On the other hand, buyer's agents must understand that seller's agents have no duty to investigate any of the information or data disclosed as provided by the seller — the seller's agent need not make an effort to authenticate its accuracy or truthfulness before passing it on to the prospective buyer.

However, as a minimum effort to be made before handing a prospective buyer information received from the seller, the seller's agent must:

- review the information received from the seller;
- include comments about the agent's actual knowledge and observations he made during his visual inspection of the property which expose the inaccuracies, inconsistencies, false nature or omissions in the seller's statements; and
- identify the source of the information as the seller.

**The dumb agent rule for SFRs**

A seller's agent on a one-to-four unit residential property owes **no affirmative duty** to a prospective buyer to gather or voluntarily provide the prospect with any facts unknown to the seller's agent about:

- the property's *title conditions*, consisting of encumbrances which a preliminary title report would disclose, such as easements, Covenants, Conditions and Restrictions (CC&Rs), legal descriptions, trust deed provisions, etc., other than assuring compliance by the seller with disclosures about liens for improvement district bonds, such as Mello Roos bonds;
- the **operating expenses** for the property (and any tenant income) the buyer will experience during ownership, such as utilities, sanitation, property taxes, yard and pool maintenance, insurance, etc., except the statutory disclosures the seller must make about any fire hazard clearance requirements which exist due to the property's location (NHD) [See **first tuesday** Form 314];
- the **zoning** or other **use restrictions** which may affect the buyer's future use of the property, except for the existence of industrial zoning which affects the property, and nearby military ordnance locations;
- the **income tax aspects** of the buyer's acquisition (or seller's disposition) of the property, such as limitations on interest deductions, avoidance of profit tax by exclusion or exemption on the sale of other property (on which the purchase of the listed property may be contingent);
- the **suitability of the property** based on the facts disclosed to actually meet the buyer's objectives in the acquisition, be they financial, legal, possessory, etc.; and
- information or data on any **mixed use** of the property, such as acreage included in the purchase for use as subdividable lands, groves or other farming operations, or for use for tenant income or as a vacation rental.

Further, the seller's agent owes no duty to prospective buyers to give advice, make recommendations, offer suggestions, comment on the extent of the adversity of the (adverse) facts disclosed, offer assistance (locate boundaries), investigate (due diligence), state an opinion or explain the effect on the buyer of any facts about the property's physical, natural or environmental conditions which have been provided by the seller's agent.

However, **when asked** by the prospective buyer or a buyer's agent about any aspect, feature or condition which relates to the property or the transaction in some way, the seller's agent is duty-bound to respond fully and fairly to the inquiry. The response must include material facts known to the seller's agent about the subject matter of the inquiry and be free of half-truths and misleading statements.

Conversely, it is the buyer or the buyer's agent who has a **duty to care for and protect** the buyer's best interests in the purchase of property. The buyer's agent, not the seller's agent, must determine what due diligence efforts are necessary to learn the extent to which the facts disclosed by the seller's agent interfere with the buyer's expectations for the use and enjoyment of the property before allowing the buyer to make the decision to purchase or close escrow.

**Opinions in lieu of factual investigations**

Consider a seller's agent of a residence who is asked by a prospective buyer to point out the location of the boundaries for the lot on which the home is located. The agent does not provide the buyer with the metes and bounds description contained in subdivision maps or tells the buyer to investigate the location of the boundaries himself. Instead, the agent says the boundaries are represented by a fence which surrounds the property — an absolute statement, indicating fact rather than opinion.

The buyer further indicates he intends to have a pool built for the use of his family if he acquires the property.

The seller's agent does not respond to the buyer's statement about his intent to build a pool. The agent has no actual knowledge of easements or zoning ordinances which could adversely affect implementation of the buyer's intended future use of the property.

Further, the buyer asks the seller to confirm whether the fences are the outside parameters of the property. The seller indicates the fences demarcate the division line between the properties.

Without further investigation, a purchase agreement is entered into by both the prospective buyer and the seller.

In preparation of the purchase agreement offer, the agent does not include a **contingency provision** to provide the buyer with an opportunity to verify the location of the boundaries or to confirm his ability to obtain a permit to build a pool as a condition for closing escrow.

Prior to closing, the title company does not ask for nor is a surveyor brought in to establish the boundaries. Neither the local planning department nor a pool contractor is consulted about the ability to obtain a permit to build a pool.

The actual facts place the location of the rear fence several feet beyond the property line, giving the rear yard the actual appearance of having sufficient room to accommodate a pool, which it will not. Also, an easement for water lines and a sewer line runs across the entire rear of the property, as well as along one side of the home allowing these services to be supplied to a rear, uphill property.

Here, the buyer acted in reliance on the agent's (and seller's) opinion about the location of the boundaries in his decision to close escrow. As a result, liability for the boundary discrepancy will be imposed on the agent for his failure to conditionalize his statement about the location of the boundaries.

Without qualifying his statement, the agent misrepresented the actual location of the boundaries. He should have either identified the source of the information as coming from the seller or included a contingency provision for the buyer's further approval of the location of the fence and ability to build a pool.

Further, the agent, due to his lack of actual knowledge of the easements, has **no liability exposure** for his failure to disclose the easements (unknown to him) which further interfered with meeting the announced interest of the buyer to build a pool. The seller's agent did not owe the buyer a duty to advise him of the need to check title for any easements or restrictions which might interfere with the construction of a pool until the buyer made an inquiry.

The seller's agent conducted a visual inspection of the property and observed nothing which indicated the existence of an easement. Further, he knew nothing about any such easement and, importantly, had no duty to investigate the condition of title or zoning since they are public records and go beyond observations resulting from a visual inspection.

**Reliance on unconditional statements**

Since the buyer made an inquiry (boundaries) and announced an intended use of the property (improvement), the information about the subject matter of the inquiries and the announced use became material facts. When a seller's agent responds, as he must, to an inquiry by a prospective buyer and gives information without conditionalizing his statement, the buyer may rely on the information and proceed to acquire the property without further confirmation of the accuracy or truthfulness of the information.

Here, due to the inquiry, the seller's agent should have included a **contingency provision** in the purchase agreement. Then, the buyer would have been required as a condition of closing to further investigate and approve by waiving the contingency as satisfied. Thus, if the results of the buyer's (or the buyer's agent, if he had one) due diligence investigation into the feasibility of constructing a pool (and the location of the boundaries) were not satisfactory to the buyer, he could have cancelled the transaction.

Without the inquiry from the buyer, the seller's agent would not have volunteered his opinion about the location of the boundaries. Thus, without the inquiry he would not have gone beyond

his minimum required disclosures about the physical condition of the property. Once he did respond to the request of the buyer, a contingency provision for further approval of the condition included in the purchase agreement would have avoided the dispute (and possibly the sale).

**In response to an inquiry**

A seller's agent on a one-to-four unit residential property owes no duty to a prospective buyer to address the existence, much less the nature, of an easement located on the listed property since they are public records.

However, when the seller's agent responds to an inquiry by the prospective buyer by providing information on the easement, he must state fully and fairly, without deceptive or misleading wording, his knowledge about the easement.

Further, he must:

- identify the source of his information if he has not confirmed its accuracy or correctness; or

- condition his response in such a way as to prevent the prospective buyer from justifying any reliance on the information without further investigation.

Consider a prospective buyer who has no experience in real estate matters. The prospective buyer deals directly with the seller's agent of a property which seems suitable to the buyer. The prospective buyer observes a 30-foot easement on the subdivision map running the entire width of the frontage to the property. When the buyer asked about the easement, the seller's agent explained it is "for those water lines you find on the curb of the street, it is nothing to worry about."

The prospective buyer decides to buy the property and build a home on it. In escrow, the preliminary title report (prelim) also reflects the easement. On further inquiry by the buyer, the seller's agent again assures the buyer the easement is on the front side of the lot and is not a problem due to the large setbacks.

After close of escrow and commencement of construction of a residence, the local water company digs a ditch 16 feet deep and installs a major waterline. The interference of the easement causes the buyer to relocate his driveway to the side street entrance since placing the driveway over the easement would require the buyer to remove it at his expense should the water company again need to access the easement in the future.

The buyer makes a demand on the seller's agent for lost value paid for the property. The buyer had relied on the seller's agent's representation that the easement presented no problem to his use of the property, when in fact it did.

Here, the seller's agent, having responded to an inquiry from the prospective buyer on the nature of the easement, must be candid in his explanation of the significance of the buyer's limited

ability to use the portion of the lot burdened by the encumbrance of the easement. Instead, the seller's agent gave evasive answers calculated to stifle and avoid the buyer's further investigation.

The buyer's inquiry is entitled to a response based on the seller's agent's working knowledge of the underlying facts or identification of the source of the information given. If the seller's agent lacks sufficient knowledge to comment, he is duty-bound to say so.

**Ads based on seller information**

A seller's agent may use information obtained from a seller concerning the size of a property in an **advertisement** offering property for sale, such as stating a parcel contains more than one acre or a home contains 5,000 square feet. The seller's agent does not need to investigate whether this information is accurate as long as it is not known to the agent to be false, nor does the agent need to identify the seller as the source of the data.

As for the advertisement used to locate buyers, the figure given must be consistent with the observations made by the seller's agent while conducting his visual inspection of the property. However, the seller's agent is not required to measure the property or check the public records when using information in an advertisement.

Conversely, in *response to an inquiry* from a prospective buyer expressing an interest or concern about the size of a parcel or improvement, the seller's agent must either confirm the accuracy and report on the area or size, or attribute the information to his source.

For income-producing property, the operating income and expense data received from the seller can be passed on to the buyer or the buyer's selling broker and agent by the seller's agent without either confirming its accuracy or disclaiming any responsibility for its correctness, so long as the source is identified.

However, no matter how the data is presented to the prospective buyer, the seller's agent is the conduit for information received from the seller. The seller's agent must first review it and, if he has no knowledge the data might be suspect, inaccurate or a misrepresentation, provide it to the prospective buyer and indicate the seller is the source of the data.

By identifying the source of the information, the seller's agent demonstrates the information **does not constitute the opinion** of the seller's agent.

**Sufficient notice to alert the buyer**

Consider a seller's agent of a condominium unit who is aware other units in the project have suffered water intrusion damage. Also, he is aware the homeowners' association (HOA) has filed a lawsuit against the developer to recover the cost of repair for the water intrusion damage in the affected units.

The agent conducts his statutorily mandated visual inspection of the unit, but finds no visible signs of water damage in the unit. The seller claims none exist.

A prospective buyer is located who is not represented by a broker. The seller's Condition of Property disclosure (TDS), which includes the seller's agent's observations, is handed to the buyer.

The TDS discloses the seller and the seller's agent know of no water intrusion damage in the seller's unit.

Further, the seller's agent advises the prospective buyer about the existence of HOA litigation over water intrusion damage in other units within the project. The buyer does not further inquire or comment on the HOA litigation or water damages to the project.

The buyer then makes an offer to purchase the property as prepared by the seller's agent. The offer contains wording acknowledging the buyer's awareness of the HOA's water intrusion lawsuit and receipt of the TDS, as well as other mandated disclosures.

Later, the seller's agent receives newsletters and minutes from the HOA's meetings which further discuss the previously disclosed water intrusion problems. The seller's agent also reads the HOA's complaint against the developer. The documents contain no new information and are not brought to the attention of the buyer.

Escrow closes and the buyer moves into the unit. Later, the buyer discovers pre-existing water intrusion damage to the unit.

The buyer claims the seller's agent owed him a **general duty** to pass on all documents known to exist concerning the extent of the water intrusion damage in the development, such as the newsletters, minutes from the HOA meetings and a copy of the lawsuit filed by the HOA.

Did the seller's agent sufficiently inform the buyer about the water intrusion problem to place the buyer on notice that a water intrusion problem existed?

Yes! The seller's agent disclosed the essential facts necessary to notify the buyer about the water intrusion damage. Once informed of the potential problem within the project, it was the buyer's duty (or the buyer's agent's duty) to exercise reasonable care to protect the buyer.

With notice of the problem, any further details concerning the extent or nature of the water intrusion were readily ascertainable by the buyer on request of the seller's agent, the HOA or a third-party investigator. It was not the duty of the seller's agent to also advise the prospective buyer to investigate the consequences of the facts disclosed before deciding to buy. [**Pagano** v. **Krohn** (1997) 60 CA4th 1]

Also consider a seller who previously received a Solar Shade Control Notice from his neighbor, who subsequently installed a solar energy collector on the neighbor's property.

While the seller is not mandated by law to voluntarily give a copy of the notice to any prospective buyer, the seller's agent should have the seller hand the notice to the buyer or the buyer's agent when delivering the TDS.

A prudent buyer's agent will likely include a solar shade notice contingency in the purchase agreement. [See **first tuesday** Form 150 §11.12]

Trees or shrubs which shade more than 10% of a neighbor's solar energy collector can be deemed a nuisance by the neighbor. Having the seller voluntarily give a copy of the notice to the buyer protects the seller and the seller's agent from claims of misrepresentation by omission. The basic information gives the buyer sufficient notice to alert him to conditions which might affect the buyer's future use of the property. [Calif. Public Resources Code §25982.1]

*Editor's note — If the seller sent notices to neighbors prior to installing a solar energy collector, he should voluntarily provide the buyer who purchases the property with a list of everyone he sent the notice to.*

**Timely disclosures are made prior to acceptance**

Consider a buyer's agent who represents a prospective buyer of a one-to-four unit single family residence (SFR). The buyer's agent makes an inquiry on behalf of the buyer into a home he locates on a multiple listing service (MLS). The seller's agent responds by advising the buyer's agent the property is still for sale as listed.

The buyer's agent and the prospective buyer inspect the property and determine that it meets all of the buyer's needs. The buyer's agent requests a property marketing package from the seller's agent in order for the buyer to make an informed decision about price and terms, or that he even wishes to buy the property, before preparing an offer.

The seller's agent does not provide the buyer's agent with a **marketing package** detailing the seller's agent's diligent inspection and investigation into the property he is marketing. The buyer's agent is informed all disclosures will be made according to standard operating procedure, as provided in the trade union purchase agreement, after an offer is accepted and escrow is opened.

Frustrated but deferring to the seller's agent's operating procedure, the buyer's agent prepares and submits an offer on behalf of the prospective buyer. The seller rejects the offer as unacceptable and the seller's agent prepares a counteroffer on behalf of the seller, bargaining for a better price while making no disclosures about facts which might adversely affect the buyer. The seller's agent does not disclose any conditions affecting the property, including his knowledge of liens encumbering title which may interfere with the seller's ability to deliver title at the offered price.

The counteroffer provides a second opportunity for the seller's agent to disclose the property's **title conditions** concerning the existing liens, which he again fails to do. In addition to his failure to perform his general duty owed to the buyer in providing a complete marketing package to the buyer's agent, the seller's agent likewise fails to protect his seller from liability resulting from the undisclosed liens on the property by including a short sale contingency addendum with the counteroffer.

The buyer accepts the counteroffer, which was structured as a cash-to-new-loan sales transaction, and escrow is opened. In reliance upon his right to acquire the seller's home and unaware

of recorded facts about the property's condition that might interfere with his expectations for purchasing the property, the buyer closes escrow on the sale of his primary residence. He incurs expenses related to his preparation for taking ownership and possession of the seller's home.

Information about the clouded condition of the property's title, known to the seller's agent prior to the seller's contracting with the buyer, is discovered by the buyer in a **preliminary title report** (prelim), obtained and handed to his buyer's agent by escrow.

The prelim details lien amounts on the property in excess of the negotiated price set in the purchase agreement. The seller is unable to perform his obligations to deliver title and close escrow since the seller's lenders will not accept his net sales proceeds for reconveyance of the trust deeds.

Due to the seller's insolvency, the buyer is unable to force the seller to perform and deliver title, which would require the seller to pay the shortage. Thus the buyer exercises his right to cancel due to the seller's material breach of the purchase agreement. On cancellation, the buyer suffers losses due to the seller's inability to convey title free and clear of all encumbrances.

The buyer then makes a demand on the seller's agent to recover the money losses he incurred after selling his home based on expectations set by the seller's agent's conduct when the purchase agreement was entered into that the seller would be able to perform — nothing to the contrary was disclosed.

The buyer claims the seller's agent is liable for his losses since he had a duty to disclose all property conditions that might have an adverse effect on the buyer, including the existence of liens encumbering the property for amounts in excess of the contract price – and do so **prior to acceptance** of an offer.

The seller's agent claims he is not required to disclose the seller's clouded title condition as encumbered with mortgage liens prior to the acceptance of an offer since to do so would require him to breach his fiduciary duty owed exclusively to the seller by revealing confidential financial information — a violation of his trade union's code of ethics.

Is the seller's agent liable for the buyer's losses if he fails to disclose, prior to acceptance of an offer, that the title is encumbered by liens in excess of the contract price, rendering the seller possibly unable to deliver title as agreed?

Yes! The seller's agent has a general duty owed to prospective buyers to disclose information before an acceptance occurs regarding risks, known to the agent, that affect the seller's ability to perform as bargained so the buyer can make an informed decision whether or not to enter into a purchase agreement. [**Holmes** v. **Summer** (2010) 188 CA4th 1510]

A seller's agent fails to perform his general duty owed to the buyer to disclose his knowledge of material facts when information that might possibly affect the buyer's decisions regarding an offer is withheld. It is the seller's agent who sets the buyer's expectations for the desirability of the property and the ability of the seller to deliver the property in the condition as disclosed prior to the moment an offer is accepted.

These expectations are set by both the information the seller's agent does and does not provide. The absence of information about adverse conditions, either known or readily available to the seller's agent, is as powerful in forming the buyer's expectations of a property as an explicit and timely disclosure. The buyer must be put on notice of adverse property conditions **prior to acceptance of an offer.**

**Minimum level of disclosure**

A seller's agent locating a prospective buyer for his client's one-to-four unit residential property owes a duty to the prospective buyer to conduct a reasonably diligent visual inspection of the property for defects which adversely affect the value of the listed property. On completing the inspection, the seller's agent must note on the (seller's) TDS any defects observable or known to the seller's agent which are not already noted by the seller or are inconsistent with the seller's disclosures. The TDS is to be handed to prospective buyers as soon as practicable (ASAP). [CC §§2079 et seq.]

However, the visual inspection and investigation of one-to-four unit residential property by the seller's agent and the disclosure of his knowledge and observations excludes other readily available information not already known to the seller's agent, such as knowledge that would be obtained by:

- the inspection of areas reasonably and normally **inaccessible** to the broker;
- the investigation of **off-site areas** and areas surrounding the property; and
- the inquiry into or review of **public records** or permits concerning title or use of the property. [CC §2079.3]

However, the minimum disclosure rule for seller's agents does not apply to a buyer's broker or his agents, much less limit the buyer's agent's duty to fully and fairly inform and advise on what investigations the buyer should undertake.

Further, the minimum one-to-four unit inspection and reporting requirements imposed on seller's agents excludes the common law duty still imposed on seller's agents of other types of property to further investigate and disclose to buyers or sellers any material facts he discovers regarding:

- title conditions;
- the financial consequences of owning the property, such as the property's operating costs; or
- the tax aspects of the transaction (seller only).

**Purpose of inspection**

The one-to-four unit disclosure limitation on seller's agents serves to set a minimum level of information and data to be disclosed to put the buyer and the buyer's agent on **notice of physical defects** in the property which are **observable or known** to the seller or the listing broker and his agents.

For example, a prospective buyer for a property on a hillside is located by the seller's agent. The buyer is informed a neighboring owner has had problems with underground water on his property and that he installed a pump to manage the high water level. The seller's agent also tells the buyer the neighbor's property previously suffered landslide damages, including a back fence that was removed due to erosion.

The seller's agent provides the buyer with a geological report the seller had acquired regarding the property. The report indicates the property lies within a geological hazard area and is susceptible to landslides and groundwater buildup.

When asked by the buyer, the seller also discloses the pool is located in the front yard since a fault line runs through the backyard.

After a review of the disclosures, the buyer makes an offer to purchase the property.

The seller's agent prudently (without legal compulsion) includes a further-approval contingency provision in the purchase agreement to reduce the risk of litigation. The contingency provision calls for the buyer to further investigate the hazards by obtaining his own geological report and approving it as a condition of closing.

Before closing, the buyer obtains a report which states the property shows signs of instability and confirms that a high groundwater level exists. The report also states the house does not show signs of cracking or distress.

During the escrow period, the seller's agent attends a meeting between area homeowners and county officials in which the geological hazards of the properties in the area and possible solutions are discussed.

The seller's agent does not inform the buyer of the occurrence of the meeting or the topics discussed since no information previously unknown to the agent and undisclosed to the buyer was released.

Later, after escrow closes, the residence slides down the hillside and is condemned by the county as uninhabitable.

On a complaint filed by the buyer, the Department of Real Estate (DRE) attempts to revoke the seller's agent's license claiming the subject matter of the meeting held by county officials was itself a fact which should have been disclosed to the buyer by the seller's agent since the mere occurrence of the town hall meeting might have affected the buyer's decision to buy.

However, the seller's agent was the **exclusive representative of the seller** of one-to-four residential units and only had a general nonfiduciary duty of disclosure to the buyer, which is limited to:

- providing the buyer with all existing geological reports held by the seller or the agent; and

- disclosing groundwater and landslide problems known to the seller's agent which occurred on the property or in the neighboring area.

Here, the seller's agent properly disclosed the geological hazards of the property by alerting the buyer to the potential problems. The homeowners' meeting was not required to be brought to the buyer's attention since the meeting was a review of the geological hazards already known to the agent and disclosed to the buyer.

Also, the buyer's independent investigation under the further-approval contingency did not deter the buyer from proceeding with the purchase of the residence.

Thus, the seller's agent did not violate the limited general nonfiduciary duty he owed to the nonclient buyer to disclose sufficient information on adverse property conditions to put a prospective buyer on notice so he (or the buyer's agent) could take steps to protect and care for the buyer's best interests.

Thus, the DRE cannot revoke the seller's agent's license for limiting his disclosures to the initial notice of the defect in the property without further elaboration. [**Vaill** v. **Edmonds** (1991) 4 CA4th 247]

# Chapter 2 Human resources: (be)low-level management by brokers

*This chapter comments on the rapid and wasteful turnover of entrants into the real estate profession.*

***Chapter 2 Outline***

*The entry and exit of agents*
*Agent population movement*
*The emerging consequences*
*Large brokerage office production*
*Preparing for the next cyclical phase*
*Solving the dropout problem*
*The broker takes charge*
*The myth of "too much control"*

***Chapter 2 Terms***

| | |
|---|---|
| *Disciplinary action* | *Runner* |
| *Independent contractor* | *Sales agent population* |
| *Millennium Boom* | |

**The entry and exit of agents**

In 2004, 53,530 original real estate salesperson licenses were issued to individuals by the Department of Real Estate (DRE). Four years later, on expiration of all these licenses at the end of 2008, 62% (33,283) of the agents originally licensed in 2004 **no longer participated** as licensees rendering services in real estate transactions because they either failed to renew (23,159 or 43%) or renewed as inactive, unemployed licensees (10,124 or 19%).

Thus, of all the agents originally licensed in 2004, only 38% (20,247) remained active in the practice of real estate brokerage by 2009, four years on.

The monthly influx of new agents has remained nearly constant since October 2007, between 1,000 and 1,300 monthly, with an enduring gradual decline thanks to the current state of the housing market.

**Agent population movement**

Roughly 50% of the individuals coming into real estate as new sales agents will leave the real estate profession by letting their licenses expire at the end of their first four-year license period. Roughly one third of those who renew their sales agent license will not be employed by a broker; they will not be involved in real estate transactions as agents.

Thus, around one third of the 55,000 individuals who received their licenses in 2006 will be actively participating as agents in real estate transactions in 2011. Of the 18,000 licensees remaining active after entering in 2006, around 5,000 will have become brokers.

The number of new sales agents entering the real estate profession has stabilized at around 14,000 per year. This trend will likely continue through 2014 until Generation Y finally starts entering the real estate market as first-time homebuyers at ages 30 to 35.

Home sales will again rise and peak as Generation Y household formations peak between 2016 and 2018, 30 years after their parents created the real estate boom of the mid-to late-1980s. This activity will bring an increase in new agents sensing easy earnings with increasing sales volume and rising prices.

However, the new sales agents entering after 2008 will be of a different mind-set and talent than the mostly “hit-and-run” types who entered in 2003 through 2007. This incoming batch will be more dedicated and more likely to possess long-term expectations. Their plans and goals will cause fewer of these future entrants to drop out by the end of their first four years. Many will be from families owning investment property or with brokerage backgrounds, and will enter for far better reasons than to get rich quick.

Sales agents who have upgraded to broker status have already found their sea legs in the real estate industry. Thus, a far greater percentage of them will remain active throughout the remainder of the current California real estate recovery.

**The emerging consequences**

The precipitous decline in the number of real estate agents entering the profession coincides with the decline in sales of real estate. In early 2008, seven percent (1 in 14) of all single family residences (SFRs) in California stood vacant. They were owned by speculators, as second homes (which were also acquired in the height of speculative fervor) or as real estate owned (REO) foreclosure properties.

Many of the speculators were first-time agents who were only suited to function in a real estate market during a boom phase. While the current batch of entrants are embracing more sustainable, long-term real estate strategies, the quick-buck type of real estate agent is swiftly exiting the stage and taking with them the artificial support they and other flippers gave and will continue to intermittently give to sales numbers — part of the REO fever running its course in around 2013.

The fever to speculate, while never entirely gone, will not likely rise again until around 2015, unless the flood of foreclosed REO properties hitting the market in 2011 and 2012 continues to drive prices down. In the interim, builders and existing homesellers will have to get rational about pricing and listing periods due to the lack of intensive competition between agents to manufacturer sales which helped push prices up in 2003 through 2005, and sustain artificially high levels in 2006 and 2007 as prices declined before the crash in 2008.

Also, the return to the slower-paced fundamental of lending pushed prices all type of properties down during 2009 and 2010, particularly in high-end properties. Further, agents intent on flipping are no longer around to load their friends, relatives, and social, civic, or religious contacts with properties. All of these agent interactions contributed to the price “bubble.”

An increase in real estate licensee misconduct is yet another consequence of the influx of agents during the *Millennium Boom*. As real estate entered a boom-phase in the market cycle, agents began entering the licensee-force en masse, seeking the easy money any booming industry promises. The real estate agent population in California spiked from roughly 200,000 in 2001 to nearly 400,000 in early 2008.

The timing of this dramatic increase in agent population coincides perfectly with the vicissitudes of the market cycle. The 200,000 agents practicing in 2001 were established as licensees during a stable real estate market. As the market began its steady ascent to peak-prices in January 2006, individuals lured by the promise of easy money began the licensing process and, unfortunately for them, became active just as the pot began boiling over (mid-2005) and exactly the same time the Federal Reserve (the Fed) belatedly stepped in to shut down the excesses.

As the *sales agent population* nearly doubled during the **Millennium Boom**, broker population remained virtually static, leading to a great disparity in the **agent-to-broker ratio**.

In 2001, there were approximately 2.5 sales agents for every individual broker licensed in California — a hallmark of a stable and healthy real estate market, which was maintained for most of the prior decade. After the prodigious influx of agents over the ensuing years of the Millennium Boom, the agent-to-broker ratio stretched to nearly 4.5 sales agents for every broker, thus doubling the number of agents each broker on average must supervise.

As a greater number of sales agents enter the real estate industry during a period of decline with fewer brokers to train and supervise them, instances of misconduct and the resulting *disciplinary action* increase. DRE **disciplinary action** taken against real estate brokers and agents has spiked 60% since 2007, revealing an unsettling trend as we emerge from the depths of the real estate market crash.

The growing disparity within the agent-to-broker ratio and the attendant increase in licensee misconduct stands as both a reminder and a grave warning to real estate brokers: you bear the responsibility for the indiscretions of your agents. It is your duty, above all else, to train a competent and responsible workforce of real estate sales agents and thus fulfill the duty of care you owe to the public.

**Large brokerage office production**

In the past, large SFR brokerage operations with branch offices depended largely on the flood of newly-licensed agents to fill their offices by occupying space, called cubbies. While the turnover was high due to agents burning through contacts without developing a viable client base, the broker and office managers were able to mitigate the turnover by aggressively soliciting new

licensees and quickly bringing in fresh replacements. The source of these list-and-run agents has dropped dramatically from 5,000 new entrants monthly during the peak licensing years of 2003-2007 to 1,300 monthly since October 2007.

When viewed in this context, and not the context of vanished buyers, economic reality is forced brokers operating branch offices to shutter the least productive branches, release the weakest office managers and under-performing agents, and relocate agents who generate business to other branches.

Even more troubling for large brokerage operations is the bickering arising over their fee-splitting arrangements with their agents who are making fewer sales and at lower prices/fees. Meanwhile, the broker is taking in fewer dollars per sale and shouldering the costs of overhead, promotion, and servicing excessive listings.

Gradually, agents employed by large brokerages consider becoming brokers or teaming up with other agents and a broker in smaller operations in an effort to reduce the fee percentage due the broker. These agents too often do not have the business acumen to set up and operate a brokerage office, even if it is their own one-man operation. They do it believing, rightly or wrongly, that their current broker is getting too large a share of the fees.

**Preparing for the next cyclical phase**

Large brokerage offices need to retrench and develop more efficient operating methods if they are to remain competitive and attract clientele. During boom times, large offices had the luxury of keeping low-producing agents on staff; brokers earned enough to gamble on the off-chance a low-producing, marginal agent would actually close a sale. Even with a dearth of newly arriving agents to fill desk space today, the nonproductive (and even the under-productive) agents may have to be released.

Brokers who learn to cut overhead and eliminate operating inefficiencies during and following the recovery years will be in the best position to profit from the up-tick in sales volume which will likely begin in 2012.

Planning ahead will be a defining characteristic of brokers who will still be operating in 2011, ready to get in on the action the next time Wall Street turns money loose on the public, as it will.

Age demographics will supply large numbers of homebuyers between 2012 and 2017, and a hoard of speculators will be right behind them, competing with them to buy properties. All this will push the housing market into another boom and the prices up, just as if there had never been a bust in 2008.

**Solving the dropout problem**

The rate of attrition for agents entering the real estate profession suggests that fully one third of the new licensees are not qualified by education, temperament or experience. They should not have been licensed or hired in the first place.

Possibly, the attrition is due to the brokerage community's inability or unwillingness to give new licensees the administrative oversight, technical training, apprenticeship, structured routine and organizational support necessary to attract and retain individuals seeking to enter the business of real estate services as a life-long profession.

Also contributory is the disruptive cyclical nature of boom and bust within the real estate industry, reflected in the number of entrants from year to year and highly volatile sales volume and pricing (and broker fees), a factor which aggravates the turnover rate.

Alternatively for those who became licensed in 2005, the DRE guidelines for licensing were too permissive, i.e., the threshold to obtain a license was low.

Becoming licensed as a real estate agent until October 2007 bordered on being a "no-brainer," especially for individuals with a little tenacity. All that was needed to qualify to take the state exam and become licensed was the completion of one course — principles — and online at that.

However, passing the state licensing exam in those years required more instruction than just a principles course. Thus, a **"boot-camp"** style, weekend cram course (or some other equally intense program) designed solely to pass the state exam was needed to supplement the principles course in order for most individuals to pass the state exam. No further real estate education was required beyond the principles course.

This preparatory course for the state exam is not education since it does not contribute to the competence of the individual for purposes of acting as a real estate agent on behalf of a broker. The DRE has been criticized by other state agencies for this failure and may change their testing procedure to reflect actual conditions experienced in practice.

Even with the requirements today of three college level courses to become licensed, new real estate agents come to the real estate brokerage world without any practical experience and insufficient effective education to assist, much less advise, the clients who retain the services of their broker.

A step in the right direction would be two years of on-the-job training for a new agent as an assistant, sometimes called a *runner*, to his broker or an experienced agent in the office. The agent then learns the ropes under a high-volume agent in the office, or with the office's transaction coordinator.

At some point, the agent's level of competence is sufficient to satisfy the broker to allow them to operate on their own and report directly to the broker or office manager rather than a team leader. Industrial and commercial brokers tend to follow this course of action.

Given that the motivation to amass as many listings as possible is still deeply entrenched in the rabbit and greyhound mentality of the broker, evidenced by the listing chart on the wall and the sell, sell, sell tone of weekly meetings, the DRE must institute a new regulation to require all brokers who employ agents to obtain a mandatory office management endorsement.

If such an endorsement were required for all employing brokers in the state of California, proper agent supervision would be held out as a necessity in the eyes of the DRE, rather than an inconvenience. We would see the number of disciplinary actions decline dramatically after a period of concerted DRE audit efforts resulting in a better protected public.

In addition to proper management and supervision, brokers must resume their role as the sales agent's mentor if the current culture of misconduct is to change. A new agent should be coupled with an experienced broker for at least 12 months (a **runner** learning the lay of the track). It behooves a newly licensed agent to find a broker who will train them. The education component of the licensing process is abstract knowledge until it is put into practice. Newly minted agents are never capable of hitting the ground running with no one looking over their shoulder to ensure proper behavior.

**California's Office of Real Estate Appraisers (OREA)** has instituted a very successful license trainee requirement that would serve as a valuable template for brokers. A newly licensed appraiser must serve under the supervision of a seasoned appraiser in good standing and gain official approval of his readiness for independent licensee activities. Additionally, the supervising appraiser is only allowed to train three agents at one time. In the event the OREA is merged with the DRE, which first tuesday highly recommends, the rule would be in-house and easily implemented among brokers and their agents.

### The broker takes charge

To operate a successful brokerage office, the broker must employ viable agents.

It is the quantity and quality of agents that produce the end result sought by brokers to be successful, i.e., broker fees.

As in all service businesses, the linchpin for achieving success is the ability of management to orchestrate the efforts of qualified agents.

However, most brokers employing agents tend not to dedicate sufficient energy to the supervision of their agents. A level of seemingly deliberate neglect prevails in most single family residential brokerage offices, consistent with the proverbial "dumb agent rule."

Thus, agents are left to learn the trade by observation or some third-party training, and to hone their skills by trial and error. This is an empirical result based more on the agents' good instincts than on training, procedural policy and constant supervision by the broker — all required by law.

Brokers need to be more than distant observers limited to providing remote oversight for the agents. They or their administrative assistants and managers must learn to supervise and police the business-related conduct of their agents.

Supervisory conduct includes:

- setting the production goals to be attained (listings and sales);

## Figure 1

**AGENT'S INCOME DATA SHEET**

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

**NOTE:** This income and expense worksheet is used to assist an agent or associated broker in an analysis of the income and expenses now experienced or likely to be experienced while employed by a brokerage office for the coming one-year period and to estimate the entry or change-of-office costs.

**DATE:** ____________, 20______
Brokerage office: ______________________

**ANNUAL INCOME AND EXPENSES:**

1. **Gross Brokerage Fees** [See instructions at line 11.4] . . . . . . . . . . $______________ 100 %
   - 1.1 Franchise fee disbursement ( ______% of § 1.) (–) $______________
     - a. Subtotal . . . . . . . . . . $______________
   - 1.2 Broker retains ______% of ☐ §1., or ☐ §1.1a. . (–) $______________
2. **Gross Fees due Agent** . . . . . . . . . . $______________ ______%
3. **Transaction Deductions by Broker:**
   - 3.1 Less:
     - a. E & O premium ($______________ per closing) $______________
     - b. Prior client promotion ( ______% of fee) . . . . . $______________
     - c. Listing/Transaction coordinator . . . . . . . . . . $______________
     - d. Other ______________________ . . . $______________
   - 3.2 Total charges withheld . . . . . . . . . . (–) $______________ ______%
4. **Office Expenses:**
   - 4.1 Equipment rent . . . . . . . . . . $______________
   - 4.2 Forms & manuals . . . . . . . . . . $______________
   - 4.3 Desk space and parking charges . . . . . . . . . . $______________
   - 4.4 Membership:
     - a. Trade association . . . . . . . . . . $______________
     - b. MLS fees . . . . . . . . . . $______________
     - c. Affiliations . . . . . . . . . . $______________
   - 4.5 Supplies/software updates . . . . . . . . . . $______________
   - 4.6 Postage/delivering services . . . . . . . . . . $______________
   - 4.7 Library/subscriptions . . . . . . . . . . $______________
   - 4.8 Photocopies . . . . . . . . . . $______________
   - 4.9 Equipment use charge . . . . . . . . . . $______________
   - 4.10 Total office expenses: . . . . . . . . . . (–) $______________ ______%
5. **Agent's Business Expenses:**
   - 5.1 Telephone:
     - a. Phone/fax . . . . . . . . . . $______________
     - b. Cell phone . . . . . . . . . . $______________
   - 5.2 Auto:
     - a. Gas/oil . . . . . . . . . . $______________
     - b. Repairs and maintenance/carwash . . . . . . . . . . $______________
     - c. Insurance . . . . . . . . . . $______________
     - d. Loan/lease payment . . . . . . . . . . $______________
     - e. Registration . . . . . . . . . . $______________
   - 5.3 Printing:
     - a. Farm letters . . . . . . . . . . $______________
     - b. Postage . . . . . . . . . . $______________
   - 5.4 Licensing fees and education . . . . . . . . . . $______________
   - 5.5 Internet service . . . . . . . . . . $______________
   - 5.6 Legal and accounting . . . . . . . . . . $______________

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   - 5.7 Marketing sessions . . . . . . . . . . $______________
   - 5.8 Travel/hotel . . . . . . . . . . $______________
   - 5.9 Entertainment . . . . . . . . . . $______________
   - 5.10 Insurance (business and health) . . . . . . . . . . $______________
   - 5.11 Total Business Expenses . . . . . . . . . . (–) $______________ ______%
6. **Marketing and Sales Expenses:**
   - 6.1 Printing flyers/mailer for listings . . . . . . . . . . $______________
   - 6.2 Property ads:
     - a. Newspaper/magazine . . . . . . . . . . $______________
     - b. TV/radio/web . . . . . . . . . . $______________
   - 6.3 Postage (marketing) . . . . . . . . . . $______________
   - 6.4 Property preparation . . . . . . . . . . $______________
   - 6.5 Open house (food/drinks) . . . . . . . . . . $______________
   - 6.6 Gifts on closing . . . . . . . . . . $______________
   - 6.7 Transactional expenses . . . . . . . . . . $______________
   - 6.8 Total marketing and sales expenses . . . . . . . . . . (–) $______________ ______%
7. **Agent's Net Income:** . . . . . . . . . . $______________ ______%
   - 7.1 Income, SS & medicare taxes . . . . . . . . . . (–) $______________ ______%
8. **Agent's After-Tax Income** . . . . . . . . . . $______________ ______%
9. **Other Income Sources:**
   - 9.1 Draw/Advance . . . . . . . . . . $______________
   - 9.2 Other ______________________ . . . . . . . . . . $______________
   - 9.3 Other ______________________ . . . . . . . . . . $______________
10. **Cost-of-Entry/Change-of-Office Analysis:**
    - 10.1 Marketing course . . . . . . . . . . $______________
    - 10.2 Lock boxes . . . . . . . . . . $______________
    - 10.3 Open house signs . . . . . . . . . . $______________
    - 10.4 Stationary/cards . . . . . . . . . . $______________
    - 10.5 Computer/programs/printer . . . . . . . . . . $______________
    - 10.6 Office furniture . . . . . . . . . . $______________
    - 10.7 Photocopier . . . . . . . . . . $______________
    - 10.8 Phone/fax equipment . . . . . . . . . . $______________
    - 10.9 Phone installation . . . . . . . . . . $______________
    - 10.10 Camera/printer . . . . . . . . . . $______________
    - 10.11 Vehicle . . . . . . . . . . $______________
    - 10.12 Other ______________________ . . . . $______________
    - 10.13 Other ______________________ . . . . $______________
    - 10.14 **Total Entry/Relocation Costs:** . . . . . . . . . . $______________
11. **Gross Brokerage Fee Projection/Forecast:**
    - 11.1 Annual after-tax income desired by agent . . . . . . . . . . $______________
    - 11.2 Divide by percentage of after-tax income at §8 . . . . . . . . . . (÷)______________
    - 11.3 Annual Gross Brokerage Fee needed at §1. to earn the desired after-tax income at §11.1: . . . . . . . . . . (=)______________
    - 11.4 Analyze the source of Gross Brokerage Fees at §1 by setting the price of the typical transaction Agent will close, the dollar amount Broker will receive as the Gross Brokerage Fee on the typical transaction, and the number of typical transactions Agent must close within one year to attain the Gross Brokerage Fees set as the goal at §11.3.

______________________________________________________________
______________________________________________________________
______________________________________________________________
______________________________________________________________.

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- an analysis of the agent's income and expenses [See Figure 1];
- the setting of fees needed for the agent to become financially viable as a real estate agent;
- establishing the personal routines and activities which will likely make the agent productive, i.e., overseeing the agent's management of time spent working for the broker; and
- the insistence that compliance reports be prepared and delivered periodically to management. [See **first tuesday** Forms 520 through 523-1]

Further, the broker must be actively involved in the agent's fulfillment of the duties the broker owes to clients with whom the agent has contact.

Thus, the agent knows from the beginning just what level of production is expected of him by the broker as a requirement for remaining with the office. Also, the broker will be demonstrating his expectation that the sales agent is to maintain a competitive attitude about producing listings and buyers. Further, an environment will have been created with a greater probability of producing purchase agreements and closings, which spells success for all involved.

**The myth of "too much control"**

A dilatory broker employing sales agents in his residential brokerage business frequently uses as a customary excuse for his lack of supervision the age-old, pre-1979 myth that a broker cannot tell an agent what to do, where to do it, or the amount of time the agent will spend doing it. As the myth goes, agents are not employees; they are *independent contractor***s** who must operate free from the broker's direction. If not, some unknown but adverse financial, legal or tax result will be visited upon the broker.

Agents are employees as a matter of California real estate law. They and their brokers are excluded from unemployment insurance benefits and contributions and income tax withholding on the employment of real estate agents. Minimum wages for **independent contractor** agents are only an issue if the agents are desk-bound in the office more than half the time spent working for the broker. The only other employer/employee concern is workers' compensation insurance which every broker employing a sales agent, as an independent contractor or otherwise, must carry.

A broker's efforts during an agent's apprenticeship and start-up period often fail to develop agents who remain in the business. On an agent's failure to remain with the office, the broker should conduct an internal review to determine:

- why the agent should not have been hired; and
- if they should have been hired, what would have made them successful real estate agents.

With adjustments by employing brokers in hiring, training and managing their agents, the broker's human resources will become long-term assets — the arms and legs of his business — not just replaceable bodies occupying cubicles and floor space in the office.

# Chapter 3 — The home inspection report

*This chapter introduces the seller's and seller's agent's use of a home inspection report as a formal documentation of the present physical condition of listed property for prospective buyers.*

***Chapter 3 Outline***

*Transparency by design, not default*
*The listing agent's marketing role*
*Home inspector's qualifications*
*Hiring a home inspector*
*The home energy rater*
*Reliance by buyers on the report*
*The home inspection contract*
*The home inspector's malpractice insurance*
*The inspection and report*
*The home inspector's conflicts of interest*

***Chapter 3 Terms***

*Care of selection*
*Entitled to rely*
*Home energy audit*
*Home inspector*
*Material findings*
*Non-invasive examination*
*Physical examination*
*Professional liability insurance*

**Transparency by design, not default**

A seller of a one-to-four unit residential property, on entering into a listing to sell the property, is asked to give the seller's agent authority to order out a home inspection report (HIR) from a local home inspection company as part of the seller's cost to properly market the property for sale.

The seller's agent explains the HIR will be used to prepare the seller's Condition of Property (Transfer) Disclosure Statement (TDS). The report will then be attached to the seller's TDS, both being included in the seller's agent's marketing package.

On receipt of the report, the seller could act to eliminate some or all of the deficiencies noted in the home inspection report. On the elimination of any defects, an updated report would be ordered out for use with the TDS.

The seller's TDS, as reviewed by the seller's agent and supplemented with the HIR, will be used to inform prospective buyers about the precise condition of the property before they make an

offer to purchase. Thus, the seller will not be confronted later with demands to correct defects or to adjust the sales price in order to close escrow. The property will have been purchased by the buyer "as disclosed."

**The seller's agent's marketing role**

The task of gathering information about the condition of the property listed for sale and delivering the information to prospective buyers lies primarily with the seller's agent. [Calif. Civil Code §2079]

Further, to retain control throughout the process of marketing, selling and transferring ownership, the seller's agent must be the one who requests the HIR (on behalf of the seller). The seller's agent will lose control over the marketing and closing process, and expose himself (and his seller) to claims of misrepresentation, when the buyer or the buyer's agent is the one who first orders the HIR.

As part of the seller's agent's management of the home inspection activity, the agent should be present while the *home inspector* carries out his investigation of the property. The agent can discuss the **home inspector**'s observations and whether his *findings are material* in that they affect the desirability, value, habitability or safety of the property, and thus its value to prospective buyers.

If the seller's agent cannot be present, then he should request that the home inspector call the agent before the HIR is prepared to discuss the home inspector's findings and any recommendations he may have for further investigation. On receipt and review of the report by the seller and seller's agent, any questions or clarifications they may have on its content is followed up by a further discussion with the home inspector, and if necessary, an amended or new report.

**Home inspector's qualifications**

Any individual who holds himself out as being in the business of conducting a home inspection and preparing a home inspection report on his findings during the inspection of a one-to-four unit residential property is a **home inspector**. No licensing scheme exists to set the minimum standard of competency or qualifications necessary to enter the home inspection profession. [Calif. Business and Professions Code §7195(d)]

However, general contractors, structural pest control operators, architects and registered engineers typically conduct home inspections and prepare reports as requested by sellers, buyers and their agents. The duty of care expected of licensed members of these professions by prospective buyers who receive and rely on their reports is set by their licensing requirements and professional attributes, i.e., the skill, prudence, diligence, education, experience and financial responsibility normally possessed and exercised by members of their profession. These licensees are experts with a high level of duty owed to those who receive their reports. [Bus & P C §7068]

Home inspectors occasionally **do not hold** any type of license relating to construction, such as a person who is a construction worker or building department employee. However, they are required to conduct an inspection of a property with the same "degree of care" a reasonably

prudent home inspector would exercise to locate material defects during their *physical examination* of the property and report their findings. Prospective buyers who rely on home inspection reports can expect a high level of competence from experts. [Bus & P C §7196]

However, a home inspector who is not a registered engineer cannot perform any analysis of systems, components or structural components which would constitute the practice of a civil, electrical or mechanical engineer. [Bus & P C §7196.1]

**Hiring a home inspector**

A seller's broker and seller's agent can rely on items specified in a home inspection report (HIR) to prepare their TDS for delivery to prospective buyers.

Their reliance on an HIR prepared by an inspector relieves the seller and the listing broker from liability for errors which are unknown to them to exist. However, to rely on the HIR, they must be free of simple negligence in the selection of the home inspector who inspects and prepares the HIR. Thus, the broker must exercise ordinary care when selecting the home inspector.

If **care in the selection** of a home inspector is lacking, then reliance on the HIR by the seller and seller's agent preparing the TDS will not relieve the broker or the seller's agent of liability for the home inspectors incompetence or error.

However, use of an HIR by the seller's agent does not relieve the agent (or his broker) from conducting their mandatory visual inspection. [CC §1102.4(a)]

Thus, the broker and seller's agent must look into or be aware of whether the home inspector who prepares the report is qualified. The home inspector who holds a professional license or is registered with the state as a general contractor, architect, pest control operator or engineer is deemed to be qualified, unless the agent knows of information to the contrary.

When hiring a home inspector, the qualifications to look for include:

- educational training in home inspection related courses;
- length of time in the home inspection business or related property or building inspection employment;
- errors and omissions insurance covering professional liability;
- professional and client references; and
- membership in the California Real Estate Inspection Association, the American Society of Home Inspectors or other nationally recognized professional home inspector associations with standards of practice and codes of ethics.

Remember, the reason for hiring a home inspector in the first place is to assist the seller and his seller's agent to better represent the condition of the property to prospective buyers, and hopefully reduce the risk of errors.

**The home energy rater**

Consider a first-time homebuyer who, acting on his own and without the advice of a buyer's agent, finds a fixer-upper for his starter home. He is able to foresee the costs of replacing the peeling wallpaper and obsolete bathroom fixtures, but has no practical idea about the costs of time and money to properly renovate the home.

In his first month in residence, the uncapped air conditioning ducts, badly sealed window frames and insufficient ceiling insulation cause his utility bills to skyrocket past his pre-closing estimates for operating the property as the owner. The buyer's financial options are more limited after acquiring the property than they were when he negotiated to purchase it.

As an owner, the buyer is responsible for the costs of any improvements to his home, and updating the home's energy-efficiency has the potential to become costly. Had the buyer retained a buyer's agent prior to making an offer or entering into a purchase agreement, he would likely have been advised to ask for a *home energy audit* (energy audit).

With the **energy audit** in hand, a buyer can incorporate the costs of the recommended energy efficient updates into the price he is willing to pay for the property. He can also use that information to compare the energy-efficiency of the home he is considering to other properties before making an offer. Information is powerful corroboration for justifying the terms and conditions of an offer, but it is needed up-front to do so.

In addition to ensuring the seller has hired a competent home inspector to complete the HIR, a buyer's selling broker may also insist a home energy audit be performed by a competent Home Energy Rater (Rater), which can be the home inspector.

The Rater is trained and certified by one of The Department of Energy's (DOE) certified providers:

- The California Certified Energy Rating & Testing Services (CalCERTS);
- California Home Energy Efficiency Rating System (CHEERS); and
- California Building Performance Contractors Association (CBPCA).

Home energy audit providers are private, non-profit organizations approved by the DOE as part of the California Home Energy Rating System (HERS) program. Audit providers have the exclusive rights to train, test and certify professional Raters.

Raters are trained through both classroom and field work in the theories of energy conservation and the analysis of a structure's energy related components.

After an extensive training process, the Rater is certified to do freelance energy audits, as long as his assessment of the energy conditions of the property is based on guidelines established by the HERS program. Anyone can hire a Rater to do an audit, the cost of which usually ranges between $300-$800.

Although Home Energy Raters are specially trained and certified, any home inspector may perform a home energy audit provided the audit conforms to the HERS regulations established by the California Energy Commission. [Bus & P C §§ 7199.5, 7199.7]

**Reliance by buyers on the report**

A seller's agent requesting a home inspection report should advise the home inspector that the seller, broker and all prospective buyers of the property will be relying on the report. This disclosure will avoid later (unenforceable) claims by the home inspector that the report was intended for the sole use of the seller, broker or buyer who signed the home inspector's contract. [CC §1102.4(c)]

Consider a buyer under a purchase agreement who requests a home inspection report on the property being purchased. On receipt of the report, the buyer cancels the purchase agreement. Another prospective buyer interested in the property receives the same home inspection report from the seller's agent and relies on it to acquire the property.

However, the report fails to correctly state the extent of the defects. The second buyer discovers the errors and makes a demand on the home inspector who prepared the report for the first buyer to cover the cost to cure the defects which were the subject of the errors.

The home inspector claims the report was prepared only for use by the buyer who requested the report and no subsequent buyer can now rely on it, as stated in the home inspection contract under which the report was prepared.

Here, the home inspector knew the seller's agent also received the report and should have known that the agent would properly provide it to other prospective buyers if the buyer who ordered the report did not complete the purchase. A home inspection report, like an appraisal-of-value report or a structural pest control report, is not a confidential document.

Thus, all prospective buyers of the property are *entitled to rely* on the existing home inspection report.

This reliance by other prospective buyers imposes liability on the home inspector for his failure to exercise the level of care expected of a home inspector when examining the property and reporting defects. Liability for the defects is imposed regardless of the fact that the home inspection contract and report contained a provision restricting its use solely to the person who originally requested it. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

## The home inspection contract

Provisions in a contract with a home inspector and his home inspection company which purport to limit the dollar amount of their liability for errors, inaccuracies or omissions in their reporting of defects to the dollar amount of the fee they received for the report are unenforceable.

Further, any provision in the home inspection contract or condition in the home inspection report which purports to waive or limit the home inspector's liability for the negligent investigation or preparation of the HIR is unenforceable. [Bus & P C §7198]

Should the buyer discover an error in the HIR regarding the existence or nonexistence of a defect affecting the value or desirability of the property, the buyer has no more than **four years after the date of the inspection** to file a legal action to recover any money losses. [Bus & P C §7199]

Occasionally, a boilerplate provision in the home inspector's contract or the home inspection report will attempt to limit the buyer's period for recovery to one year after the inspection occurred.

However, any such limitation the home inspector places on time periods during which the buyer must discover and make a claim is unenforceable. The statutory four-year period is needed to provide time for buyers to realize the home inspector produced a faulty report. [**Moreno** v. **Sanchez** (2003) 106 CA4th 1415]

## The home inspector's malpractice insurance

An agent ordering a home inspection report needs to verify the home inspection company has *professional liability insurance* **coverage** before allowing the company to conduct an investigation and prepare a report.

Home inspectors who fail to detect and report a material defect or the extent of the defect may cause the buyer to incur costs to correct the significant defects. The buyer will be seriously disadvantaged in any recovery effort against the home inspector and the home inspection company unless insurance is available to pay amounts due the buyer.

Likewise, if the same defect was also missed by the seller's agent due to the agent's failure to observe the defect during the agent's mandatory visual inspection, the broker and the seller's agent are also liable to the buyer for the costs of curing the defect — separate from the home inspector's liability.

Here, the broker and seller's agent will be able to force the home inspector to contribute to the recovery by an indemnification claim made by the broker against the home inspector for payment of all or a portion of the buyer's loss. Unless the home inspector has insurance coverage, the ability of the seller's broker to force the home inspection company to pay the home inspector's share of the responsibility for having failed to observe the same defect the seller's agent missed will be limited to the home inspector's personal assets. [Leko, *supra*]

## AUTHORIZATION TO INSPECT AND PREPARE A HOME INSPECTION REPORT

(Business and Professions Code §7195)

**Prepared by: Agent** ______________________ | **Phone** ______________________
**Broker** ______________________ | **Email** ______________________

**DATE**: ____________, 20_____, at ______________________________________________, California.

| | |
|---|---|
| Home Inspector/Rep. ______________________ | Agent's Name______________ DRE #________ |
| Home Inspection Company ______________________ | Broker's Name ______________DRE #________ |
| Address ______________________ | Address ______________________ |
| Phone ______________Cell:______________ | Phone ______________Cell:______________ |
| Fax ______________________ | Fax ______________________ |
| Email ______________________ | Email ______________________ |

**FACTS:**

**1.** Property address ________________________________________________________________

________________________________________________________________

1.1 Type of property ________________________________________________________________

________________________________________________________________

**2.** Owner's name ________________________________________________________________

Phone ________________________________________________________________

**3.** The home inspection report is for use in the agent's preparation of a transfer disclosure statement and reporting of the property conditions to prospective buyers.

**4.** Your contract for inspection and report will be entered into by ☐ the Owner, ☐ the Buyer, or ☐ the Agent.

4.1 ☐ Include a copy of the binder with dates of effectiveness for your professional liability insurance coverage.

**5.** Call ☐ the Agent, or ☐ the Seller, to set up the day and time for your inspection.

5.1 ☐ The Agent will be present during the inspection.

5.2 If the Agent is not present, call the Agent to discuss your findings before preparing the report.

**6.** Your inspection and report to include the following items:

6.1 An energy efficiency inspection.

6.2 Any improvements that are not in compliance with building permits or codes and any improvements for which no permit exists.

6.3 The property's compliance with safety codes for child resistant pool barriers, hot tub covers, automatic garage doors, door locks/latches, gas valves, residential security bars and water heaters.

**7.** Your fee for this service will be paid in full on your delivery of your report to the Agent.

7.1 It is anticipated the amount of your fee will be $______________.

**8.** You are authorized to open an order and process this inspection.

Submitting Agent's Signature: ________________________________________________________________

**FORM 130** 03-11 

**The inspection and report**

A home inspection is a **physical examination** conducted on-site by a home inspector. The inspection of a one-to-four unit residential property is performed for a noncontingent fee.

The purpose of the physical examination of the premises is to identify material defects in the condition of the structure and its systems and components. **Material defects** are conditions which affect the property's:

- market value;
- desirability as a dwelling;
- habitability from the elements; and
- safety from injury in its use as a dwelling.

Defects are material if they adversely affect the price a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement. As the report may affect value, the investigation and delivery of the home inspection report to a prospective buyer must precede a prospective buyer's offer to purchase to be meaningful. [Bus & P C §7195(b)]

The home inspection is to be a *non-invasive examination* of the mechanical, electrical and plumbing systems of the dwelling, as well as the components of the structure, such as the roof, ceiling, walls, floors and foundations.

Non-invasive indicates there will not be an intrusion into the roof, walls, foundation or soil by dismantling or taking apart the structure which would disturb components or cause repairs to be made to remove the effects of the intrusion. [Bus & P C §7195(a)(1); see Form 130 accompanying this chapter]

The *home inspection report* is the written report prepared by the home inspector which sets forth his findings while conducting his physical examination of the property. The report identifies each system and component of the structure inspected, describes any material defects the home inspector found or suspects, makes recommendations about the conditions observed and suggests any further evaluation needed to be undertaken by other experts. [Bus & P C §7195(c)]

The seller's agent needs to make sure the report addresses the cause of any defect or code violation found which constitutes a significant defect in the use of the property or cost to remedy the defects. The report should also include suspicions the home inspector might have which need to be clarified by further inspections and reports by others with more expertise.

The agent, or anyone else, may also request that the home inspector conduct an inspection on the energy efficiencies of the property and include his findings in the report. On a request for an **energy efficiency inspection**, the home inspector will report on items including:

- the R-value of the insulation in the attic, roof, walls, floors and ducts;

- the quantity of glass panes and the types of frames;
- the heating and cooling equipment and fans;
- water heating systems;
- the age of major appliances and the fuel used;
- thermostats;
- energy leakage areas throughout the structure; and
- the solar control efficiency of the windows. [Bus & P C §7195(a)(2)]

**The home inspector's conflicts of interest**

The home inspector who prepares a home inspection report, the company employing the home inspector and any affiliated company may not:

- pay a referral fee or provide for any type of compensation to brokers, agents, owners or buyers for the referral of any home inspection business;
- agree to accept a contingency fee arrangement for the inspection of the report, such as a fee payable based on the home inspector's findings and conclusions in the report or on the close of a sales escrow;
- perform or offer to perform any repairs on a property which was the subject of a HIR prepared by them within the past 12 months; or
- inspect any property in which they have a financial interest in its sale. [Bus & P C §7197]

# Chapter 4 — The licensee acts as a principal

*This chapter discusses a licensee's lack of a duty to disclose his real estate licensee status when acting solely as a principal in real estate transactions.*

***Chapter 4 Outline***

*No agency, no duty to disclose the license*
*Agent's duty to disclose interest in property*
*Agent disclosure of entrepreneurial benefits*
*The seller's agent takes a profit, not just a fee*
*Acting as a real estate licensee*
*Creating an agency liability where none exists*
*Licensee is still the seller*

***Chapter 4 Terms***

| | |
|---|---|
| *Acting as a licensee* | *Other principal* |
| *Agent* | *Material Fact* |

**No agency, no duty to disclose the license**

An owner of real estate holds a real estate license issued by the Department of Real Estate (DRE).

The owner markets property he owns as "for sale by owner" (FSBO). The owner is not represented by a real estate broker.

A buyer responds to the advertisement by contacting the owner directly and expressing an interest in acquiring the property. The owner makes all the necessary disclosures of data and information regarding the property's physical condition, operating data, title condition and the nature of its location, since the buyer has expressed an interest in making an offer after the initial contact.

The buyer and owner then enter into a purchase agreement which the owner prepares. The buyer does not know and is not informed the owner is a real estate licensee, and the buyer does not inquire about any licensing status of the owner. Neither the purchase agreement nor escrow instructions contain a declaration disclosing the existence of a DRE license.

After escrow closes on the sale, the buyer finds the property and the financing incompatible, and also believes he paid too much for the property. Further, the buyer discovers the seller was a real estate licensee.

The buyer attempts to rescind the transaction, claiming the seller, acting solely as a principal for his own account, breached his duty owed to the buyer to disclose his status as a licensee and protect the buyer's interests in the purchase.

Two issues arise. First, did the owner, selling property he held for his own account, at any time act as an *agent* for anyone in the transaction?

No, the owner never undertook an agency relationship to act on behalf or advise the buyer or anyone else in the transaction. A licensee acts as an **agent** in a transaction only when he represents another person. Thus, a licensee cannot act as an agent for himself — it is a legal impossibility. [Calif. Civil Code §2295]

If a licensee represents both himself and the other party in a sale or loan transaction, he has a conflict of interests as he is acting as both:

- a principal for his own account; and
- an agent for the *other principal* in the transaction.

However, the owner here did not act in his capacity as a licensee. He did not undertake the duty to represent the buyer (or others) with or without the expectation of compensation, nor did he hold himself out as a licensee to gain a benefit in the transaction, much less act as the buyer's agent in the transaction.

The second (and more germane) issue is whether the owner, acting only as a principal, has a duty to disclose his status as a real estate licensee (or as holder of any other professional license) when he markets and sells his own real estate to a buyer?

No! A principal's duty, when acting as a seller, is to disclose sufficient information to place the buyer on notice of all property conditions which are not observable or known to the buyer and might affect the buyer's decisions, but are known to the seller. The status of the property, not the seller's status as a licensee, delimits the disclosures. The buyer is acquiring real estate, not the agency obligations or services of a licensee.

A conflict of interest does not arise when a real estate licensee sells property he owns unless he acts or implies he is acting in the capacity of an agent in the transaction or on behalf of another. Further, to advertise property for sale as an "owner/agent" is a contradiction, a legal absurdity, and confusing to a buyer about the existence of a real estate agent handling the transaction. No agency exists with anyone at the time of the advertising, none should be inferred and the words "owner/agent" should never be used.

A principal-licensee conflict requiring additional conflict of interest disclosures only arises when:

- the licensee represents the buyer or seller as an agent; and
- the licensee has or will have a direct or indirect interest in the property sold or bought. [See **first tuesday** Form 527]

**Agent's duty to disclose interest in property**

When *acting as a licensee* in a real estate transaction, a real estate broker has a general agency duty to disclose to all the principals involved whether:

- the broker has or is acquiring for his own account a direct or indirect interest in the property [**Whitehead** v. **Gordon** (1969) 2 CA3d 659];
- the broker's agent or employee has or is acquiring for his own account a direct or indirect interest in the property; or
- a relative of the broker or the broker's employee has or is acquiring an interest in the property. [**Sierra Pacific Industries** v. **Carter** (1980) 104 CA3d 579]

*Editor's note — While negotiating a transaction on behalf of others as a real estate agent, a licensee who fails to disclose he is acquiring or selling an interest in the real estate, directly or indirectly, may find his license revoked by the DRE.* [**Buckley** v. **Savage** (1960) 184 CA2d 18]

**Agent disclosure of entrepreneurial benefits**

Now consider a seller of residential property who lists the property with a real estate broker.

The broker, at the time of the listing, is working with an investor to locate property suitable for investment. The investor is exposed to the listed property and becomes interested in acquiring it. The broker prepares a purchase offer for the investor at a price less than the seller's listing price, which the investor signs as the buyer.

The broker delivers the investor's written offer to the seller, which discloses the broker's dual agency in its agency confirmation provision.

The seller accepts the investor's offer.

On close of escrow, the broker enters into an exclusive listing agreement with the investor to resell the property for a listing price exceeding the seller's original listing price. The property is resold at the new listing price.

Later, the seller learns the property has been resold through the broker's office at a higher sales price.

The seller claims the broker breached his agency duty owed the seller by failing to disclose the conflict of the broker's personal interest to negotiate a lower sales price so the property could be promptly resold by the broker on behalf of the investor, flipping it for another broker fee.

The broker claims he did not breach his agency duty since the seller was fully advised he was a dual agent in the purchase agreement agency confirmation statement which the seller agreed to.

Did the broker fail to disclose a material fact to the seller and thereby breach his duty as a dual agent?

Yes! The broker failed to disclose a conflict of interest to the seller which was a material fact — the broker's personal expectation of a future business opportunity with the investor regarding the relisting and resale of the subject property. Here, the seller might have bargained for a more favorable sales price or refused to counter at all had he been aware of the broker's entrepreneurial arrangement with the investor regarding an indirect interest in the property, or that the buyer was going to flip the property in expectation of a profit. [**Jorgensen** v. **Beach 'N' Bay Realty, Inc.** (1981) 125 CA3d 155]

**The seller's agent takes a profit, not just a fee**

Now consider a broker who, while employed under a listing agreement to locate a buyer for the seller's property, prepares a purchase agreement naming himself as the buyer and submits it to the seller. The employment under the listing is not cancelled, and the purchase agreement calls for the broker to be paid a fee for acting as the seller's agent while at the same time being named and acting as the buyer.

Escrow is opened, and prior to closing, the broker locates a substitute buyer who agrees to acquire the broker's rights to buy the property. The broker's right to buy the property under the purchase agreement is assigned to the buyer and the buyer becomes the substitute buyer of the property in escrow.

The substitute buyer pays the broker a "transfer fee" for the assignment equal to 10% of the price paid to the seller.

The seller agrees to the assignment of the broker's contract rights to the substitute buyer after the broker reiterates that the property's value does not exceed the price set by the purchase agreement entered into by the seller and the broker.

At closing, the broker tells the seller he is to receive an assignment fee for the transfer of his right to buy, but does not disclose the dollar amount of the fee. After escrow closes, the seller discovers, in addition to the fee he paid the broker, the substitute buyer paid the broker 10% of the purchase price for the assignment.

The seller makes a demand on the broker for the assignment fee and the return of the brokerage fee. The seller claims the broker breached his fiduciary duty owed him and did so deceptively

since the broker failed to disclose the dollar amount of the benefits he received while acting as the seller's agent, depriving the seller of his ability to sell his property for its highest possible price.

The broker claimed he had no duty to disclose the price paid by the substitute buyer for the assignment since the broker's status under the purchase agreement as a buyer was that of a principal with an interest in the property he could sell at whatever price he may set.

Did the broker breach his fiduciary duty owed to the seller as the seller's agent by failing to disclose the dollar amount of the benefits he received on his flip of the property to the substitute buyer?

Yes! The broker's fiduciary duty created by the listing agreement was never terminated. Accordingly, the broker was required to disclose the dollar amount of all earnings resulting from the transaction. The broker did not extinguish his agency duties before entering into the purchase agreement to buy the listed property and act solely as a principal. [**Roberts** v. **Lomanto** (2003) 112 CA4th 1553]

In this case, the broker's blatant deception of the seller while he was in an agency position netted the broker a broker fee, the assignment fee paid by the substitute buyer and all the charges he did not have to pay on the resale of the property (title fees, escrow charges, etc.) — all profit and undisclosed benefits of his agency relationship with the seller, all of which he had to return to the seller.

Just because the dollar amount of the benefits a broker receives in a transaction while representing a client do not appear in any of the formal documents signed by the client (e.g., listing agreements, purchase agreements, escrow instructions), doesn't mean a broker may simply keep silent about them. A broker is bound by his fiduciary duty to voluntarily disclose any and all benefits of monetary value he receives as a result of a transaction in which he represents a principal, especially when the benefits are not stated in other documents signed by his client. [See **first tuesday** Form 119]

**Acting as a real estate licensee**

A person acts as a real estate licensee when he:

- negotiates the sale or purchase of property on behalf of another person; and
- expects to be compensated for his work. [Calif. Business and Professions Code §10131]

If **the licensee** involved in a transaction is not acting on behalf of a principal, the licensee is selling, buying, leasing or financing real estate for his own account and is merely a principal in the transaction — unless the licensee leads the other party to believe he is that party's agent.

An *agent* is a person authorized by another, called a principal, to:

- negotiate a transaction with a third person; and

- exercise discretion – give advice - in meeting the principal's objectives. [**L. Byron Culver & Assoc.** v. **Jaoudi Industrial & Trading Corp.** (1991) 1 CA4th 300]

**Creating an agency**
**liability where none exists**

The fact a seller or buyer of real estate holds a real estate license is immaterial to their sales transaction. No seller or buyer needs a license to act as a principal. More importantly, the seller or buyer are only required to be licensed if they are also acting on behalf of (representing) someone else in the sale, a prerequisite for establishing a compensable agency relationship.

However, when the seller or buyer negotiates the sale or purchase of real estate for his own account and includes payment of a brokerage fee to himself, the seller or buyer is also holding himself out as a broker who is negotiating the transaction. Once the owner authorizes the payment of a fee to himself under his status as a broker, a fact known to the other party, the broker has undertaken a general duty to honestly disclose and advise on the condition of the property, title, expenses and location to the seller or buyer. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

*Editor's note — When a licensee is a buyer or seller of his personal residence or investment properties, building a fee into the real estate transaction also produces an adverse income tax result.*

*When an owner takes a brokerage fee on a sale, the net income taken becomes skewed; part profit, part personal income. If, on a purchase the buyer takes a credit for a brokerage fee on the price paid, the fee must be declared as personal income in the year of the transaction, not as part of the basis in the investment or business asset acquired. Thus, the federal tax rate applied is up to 35%, payable now, and not limited to 15%, payable on a later resale. A fool's game.*

Consider a licensee who acts solely as the seller or buyer and conducts himself in a manner which leads the **other principal** to believe the licensee is also acting as his agent in the transaction.

Agency conduct includes an assurance to the buyer that the transaction will be handled properly since the seller is a real estate licensee. Thus, he is deemed the agent of the other party, since he disclosed his licensee status and used the existence of the license to his advantage in negotiations. [**In re Woosley** (9th Cir. BAP 1990) 117 BR 524]

**Licensee is still the seller**

When a licensee sells property he owns, holding himself out only as the seller, the licensee is required to make only the disclosures required by any seller of real estate. For instance, if the property is a one-to-four unit residence, the seller must complete and hand the buyer a Condition of Property Statement as well as a hazard disclosure. [CC §1102.3]

The seller also is required to disclose all *material facts* he knows or should have known as the seller of the property, even though he is not **acting as a licensee** on behalf of the buyer while negotiating the transaction. [**Easton** v. **Strassburger** (1984) 152 CA3d 90]

A **material fact** is any information known to the seller about the real estate which might adversely affect the buyer's decision to purchase the property. [**Holmes** v. **Summer** (2010) 188 CA4th 1510]

Other professionals whose services are real estate related, such as attorneys, loan officers, escrow officers, title officers and CPAs, are likewise not compelled to disclose their professional licensee status when acting solely as a principal in a real estate transaction.

While a real estate licensee is in the profession of negotiating the sale, leasing or financing of real estate, the licensee's profession and the expertise gained as a licensee does not impose on him a special duty to disclose his real estate licensee status when buying and selling property for his own account.

It is the converse activity which must be disclosed — when acting as an agent, you must disclose your relationship with the property or others if that relationship is in conflict with your agency.

Real estate licensing does not create a second rate citizenship. However, when a licensee buys or sells for his own account, most escrow officers drafting escrow instructions see it that way and automatically include a licensee declaration. This inclusion may well be a condition unnecessarily created which implies a general agency duty is owed the other party.

# Chapter 5 — Inking the handshake: the significance of a written employment agreement

*This chapter discusses the need for a written employment agreement to assure payment of any fee anticipated for finding a match and negotiating a real estate related transaction, and reviews the fee assurance offered by provisions in various types of listing and purchase agreements.*

***Chapter 5 Outline***

*Expectations lost for want of a signature*
*The workings of an employment agreement*
*The not-so-friendly oral fee agreement*
*A contract enforceable is prerequisite*
*Earned fee interference: prospective economic advantage*
*Open v. exclusive listings*

***Chapter 5 Terms***

| | |
|---|---|
| *Agency relationship* | *Listing agreement,* |
| *Employment agreement* | *Open listing* |
| *Exclusive right-to-sell* | *Oral agreement* |
| *Fiduciary duty* | *Tortious conduct* |

## Expectations lost for want of a signature

Real estate brokers and their agents habitually attempt to form strong personal bonds with potential clients while making themselves better known to likely buyers, sellers, borrowers, landlords and tenants of property. Indeed, all professionals require some level of self-promotion to attract and retain clientele.

Through **FARM letter campaigns** and social networking contacts, a broker and his agents seek to generate future business —employment — among potential clients looking for an agent to advise and act on their behalf.

By sharing detailed market knowledge of current sales and pricing trends along with a demonstrated understanding of the various contractual aspects of real estate transactions, an agent's worth to potential clients becomes apparent.

In practice, communications with potential clients via Facebook or newsletters are simply too casual and passive to be construed as a personal fiduciary service. Yet in the eyes of the prospective employer, these informal precedents set the tone for future representation.

When representation is undertaken, the sporty solicitations and branding efforts are legally transformed into a serious dedication of diligence and advice to meet the client's objectives for a real estate transaction.

Most clients unfamiliar with real estate related transactions willingly follow the advice and recommendations of the broker or agent they select to assist them. Thus, the broker's knowledge that real estate related agreements are to be formalized in writing sets a prudent precedent for a *written employment agreement* – commonly called a *listing*.

It may be acceptable for old pals to make promises based solely on their word, but for real estate brokers and agents acting on behalf of a client, the only appropriate deal maker is **written documentation** — a signed form prepared by the broker.

Brokers who "document" the transition of a potential client into a **principal** to whom they now owe a duty of care with nothing more than a handshake act at their peril, risking loss of their well-earned fee and setting a terrible example for their agents and the industry.

## The workings of an employment agreement

When a client agrees to representation by a broker for assistance in the purchase, sale or lease of property (or arrangement of a mortgage), the two parties enter into a *listing agreement*, an **employment agreement** worded to establish the expectations of their relationship as client and fiduciary agent. In doing so, the relationship created between the client and the broker has two separate and distinct legal aspects:

- an *employment relationship*; and
- an *agency relationship*.

The **employment relationship** created by the **listing agreement** specifies the activities a broker is obligated to undertake in his employment and authorized by contract to carry out on behalf of the client in exchange for a fee.

The **agency relationship** is imposed on the broker by law when he solicits or acts on behalf of another person. Agency carries with it the *fiduciary duties* of loyalty owed by the broker (and his sales agents) to care for and protect the best interests of the client against all competing interests. [See **first tuesday** Form 305]

## The not-so-friendly oral fee agreement

An *oral agreement* to represent a client in a real estate transaction imposes an agency obligation on the broker and all his agents to act as a **fiduciary** to that client, no different than if a written and signed employment agreement existed. However, a client's oral promise to pay a fee for the broker's services (or cause one to be paid as with a client-buyer) does not entitle the broker to enforce collection of the fee from his client.

Thus, all **fee agreements** must be in writing and signed by the client before the broker can pursue the client for collection of the amount he has earned— no matter who was to pay it. [CC §1624(a)(4)]

In other words, an **oral agreement** obligates a broker to work diligently in the best interest of the client, but does not obligate the client to pay for the effort. However friendly a broker may be with his client, oral agreements do not provide adequate assurance a fee earned will be paid by anyone.

Consider a real estate broker contacted by a prospective buyer interested in locating and acquiring property. It is agreed the broker will assist the buyer in finding suitable property for purchase. The buyer orally promises the broker will be paid a fee in the event the buyer purchases any property submitted to the buyer by the broker.

The broker then proceeds (with diligence) to locate and present suitable properties to the buyer for consideration. The buyer, interested in a property submitted to him by the broker, contacts the seller directly and purchases the property without the broker's involvement.

The broker, on discovering his client's acquisition of the property, demands payment of the promised fee he has earned. The buyer refuses to pay, claiming no writing signed by the buyer exists between the broker and the buyer for payment of a broker fee.

Is the broker entitled to his fee on the sale as orally promised by the buyer?

No! The oral agreement obligated the broker to fulfill fiduciary duties owed the buyer, which he did. However, it did not impose liability on the buyer to pay the broker a fee on his acquisition of property located and submitted by the broker as orally agreed. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

### A contract enforceable is prerequisite

Entering into a **written employment agreement** immediately upon establishing an agency relationship with a buyer or seller will ensure all parties are on the same page. [See **first tuesday** Forms 102 and 103]

The **written listing** contains the client's promise to either pay a fee or cause a fee to be paid by someone else, such as the seller in a sales transaction. The promise is given in exchange for the broker's promise to use **due diligence** in his efforts to meet the objectives sought by the client in the employment.

Consider a real estate broker who enters into a listing agreement with a seller employing the broker to locate a buyer for his property. The listing agreement, written and signed by the seller, entitles the broker to a fee should the property be sold within one year, whether or not the broker is the procuring cause of the sale, called an *exclusive right-to-sell listing agreement.*

Within one year after entering into the employment, the seller agrees to sell the property to a buyer the owner located. The sale is closed without the payment of a fee to the broker. The broker demands payment of his fee earned on the sale under his listing agreement. The seller refuses, claiming the broker did nothing to "earn" a fee.

Is the broker entitled to a fee for the sale, even though he was not in any way involved in the solicitation or sale of the property to the buyer?

Yes! Documentation of an obligation to pay a fee in the form of a **written agreement** signed by a client is the legislatively mandated and judicial requisite to the **right to enforce collection** of a brokerage fee from the seller. [**Crane** v. **McCormick** (1891) 92 C 176]

**Earned fee interference: prospective economic advantage**

Regardless of whether a signed, written listing agreement exists, nobody may interfere with the *prospective economic advantage* a broker holds with his client — a relationship, written or oral, that would have earned a fee but for the interference.

Consider a seller who places a sign on his property stating, "For Sale — Contact Your Local Broker." The sign constitutes an open listing with local brokers, who have the opportunity to procure ready, willing and able buyers and thus earn a fee should the buyer they procure purchase the property.

After seeing the property, a potential buyer approaches a local broker and they discuss the property. The buyer indicates he will contact the broker if he decides to purchase the property. The broker does not obtain an oral or written promise from the potential buyer to assure payment of a fee, but promptly advises the seller about the inquiry, identifying the potential buyer as his client.

The seller is then directly approached by the potential buyer with an offer to purchase the property without providing for payment of a fee to the broker, which the seller accepts.

The broker learns his buyer has purchased the property and makes a demand on the seller for payment of his fee earned on the sale. The seller refuses, claiming the broker is not entitled to a fee on the sale since the broker did not have a written agreement with either the buyer or the seller entitling the broker to his fee.

Is the broker entitled to a fee from the seller for procuring the buyer even though he had no written employment agreement with either party?

Yes! The seller owes the broker a fee on the sale. Here, the seller knew of the broker's employment relationship with the buyer and intentionally avoided payment of the broker's fee by selling the property without further involving the broker — an interference with the broker's p**rospective economic advantage** arising out of the broker's employment by the buyer. [Buckaloo v. Johnson (1975) 14 CA3d 815]

**Intentional interference with prospective economic advantage** is considered *tortious conduct* which imposes liability on the person collaborating with the client to avoid the fee, not the subject of contract law as is enforcement of a breached writing. When a writing does exist, those entering into it typically perform as agreed giving no rise to collection enforcement.

Instead, a third party's interference with a broker-client economic relationship is tortious interference with the broker's potential to earn a fee on a transaction entered into by his client. The tortious misconduct relates to the disruption of an economic relationship rather than the breach of a contractual promise to pay a fee.

The seller knew of the broker's relationship with the potential buyer and interfered with that relationship by selling his property directly to the buyer without the broker's involvement. Thus, the seller's conduct cost the broker his fee on the sale, a loss due to the disruption of his prospective economic advantage in the real estate transaction. [**Zimmerman** v. **Bank of America** (1961) 191 CA2d 55]

**Open v. exclusive listings**

To set the parameters of an **agency relationship** undertaken with a client, a broker must determine the type of services he will provide and the extent of assurances a fee will be paid for having entered into the employment.

A wide variety of listing agreements exist, each different in the extent of the representation and type of services to be performed by the broker and his agents, or the events which trigger payment of a fee as earned.

Listings are generally classified under one of two categories:

- *open*; or
- *exclusive.*

Under an **open listing**, also called a *nonexclusive listing*, the listing broker is not the **sole representative** of the client.

The client can enter into open listings with as many brokers as he wants without becoming obligated to pay more than one fee. Worse, the client under an open listing is in direct competition with the broker since a client-seller may separately solicit, locate and sell the property to a buyer without incurring any liability for a fee to the broker.

For a broker to be entitled to a fee under an open listing, the broker must **procure** a ready, willing and able buyer and **present** the seller with an offer from the buyer to purchase the listed property.

In contrast to the open listing arrangement, an *exclusive listing* affords a broker the sole right to represent a buyer, owner or tenant. Under an **exclusive right-to-sell listing**, only one broker may market the property and negotiate with all potential buyers and their agents.

Likewise, an *exclusive right-to-buy listing* establishes a broker as the sole licensed real estate representative of a buyer. Further, and of great importance, a client who has entered into an **exclusive-right-to-buy listing** with a broker cannot act independent of the broker and avoid payment of a fee.

**Exclusive listings** offer a broker the greatest fee protection. Under the fee provision in an exclusive right-to-sell/buy agreement, the broker earns a fee no matter who produces the buyer or locates the property sought under the listing, be it the client, another broker or any other representative of the client.

Thus, exclusive right-to-sell/buy/lease/finance listings give a broker and his agents the greatest incentive (and obligation) to work toward attaining the client's goal of locating a buyer or property. Both parties work together to accomplish the client's objective.

*Editor's note — Agents representing buyers too often neglect to establish their employment in a written agreement before exposing the buyer to properties listed by other offices. Instead, they hope to write up a purchase offer, but when they do they use a purchase agreement form devoid of a fee setting provision.*

*Worse yet, buyer's agents then rely on the inherently adversarial seller's agent to set the amount, assure enforceability and disburse the fee earned on their buyer's purchase. All the while, the buyer's broker provides no assurance through escrow he will be paid on closing.*

*In the current housing market, buyers are a rare commodity and thus tend to dominate negotiations in sales transactions. An exclusive right-to-buy listing agreement between a buyer and a buyer's agent guarantees no time, money and talent will be wasted locating property on behalf of this buyer, if they buy.*

# Conditions of Purchase

# Chapter 6 — Contingency provisions

*This chapter highlights the inclusion of contingency provisions in purchase agreements to allow buyers and sellers to either confirm their expectations and meet objectives or avoid closing the transaction.*

***Chapter 6 Outline***



***Chapter 6 Terms***

| | |
|---|---|
| *Authority to terminate* | *Litigation and liability exposure* |
| *Breach or be excused* | *Terms and conditions* |
| *Contingency provisions* | *Uniform method* |

**Conditioning the close of escrow**

The contents of a purchase agreement is a collection of provisions generally called *terms and conditions*. While **terms** focus on the price and the (terms for) payment of the price, **conditions** address:

- the **performance** by the buyer and seller of their closing activities; and
- **occurrence of events** required before escrow can close on the transaction.

Thus, each condition which is the subject of a provision must either be shown to exist or come into existence, by its occurrence or approval, before the purchase agreement can be enforced and escrow closed. Alternatively, the condition can be waived as though never part of the purchase agreement.

Thus, all purchase agreements contain one or more provisions "conditioning" closing on the "elimination of a contingency."

When conditions are the subject of *contingency provisions*, the conditions are categorized based on whether they:

- are to occur (events and activities), called event-occurrence contingencies; or

- are to be approved (information, data, documents and reports), called further-approval or personal-satisfaction contingencies.

These **contingency provisions** grant the buyer or seller, or both, the *power to terminate* any further performance of the purchase agreement should an identified activity or event fail to occur or a condition be disapproved.

Also, provisions containing conditions are also classified by the sequence or order in which they are to occur or will be performed by the buyer or seller. Thus, the occurrence or approval called for is either:

- a condition precedent to the performance of an activity by the other person, such as the seller's delivery of documents for the buyer's approval or disapproval; or

- a condition concurrent to be performed without concern for the other person's activities, such as the buyer proceeding with financing or the seller putting his grant deed into escrow.

Distinguishing conditions still further, they may be breached or excused on failure to occur. Some conditions **must be performed**, such as the seller's delivery of title, making the failure to perform them and close escrow a breach of the purchase agreement. Other conditions are the subject of contingency provisions and might not occur or be approved, in which case the failure of one or both parties to further perform and close escrow is excused.

However, under any type of contingency provision, the buyer or seller benefitting from the contingency holds an option to "do away with" any further performance of the purchase agreement and escrow instructions, called cancellation.

**Conditions precedent and concurrent**

While all contingency provisions are conditions, it must be well understood that not all conditions agreed to in the provisions of a purchase agreement are contingencies. Contingency provisions authorize the cancellation of the purchase agreement and excuse any further performance. Other conditions must be met since they are not contingencies, in which case a failure to perform becomes a breach.

For analysis, conditions found in purchase agreements which are classified by the sequence in which they are to be performed or occur are distinguished as follows:

1. Conditions precedent: consists of contingency provisions calling for the occurrence or approval of an event or condition which **may or may not occur**.

   Examples include the buyer obtaining a written loan commitment, the recording of a purchase-assist loan, approving due diligence investigations, the sale or acquisition of other property, etc. Here, the contingency provision may be eliminated by its occurrence and the transaction proceeds toward closing. Alternatively, if the event or approval is not forthcoming, the person authorized to cancel may exercise his right to terminate the transaction, doing away with any further performance of the purchase agreement and escrow instructions, called cancellation.

2. Conditions concurrent: consists of noncontingent, mandatory performance provisions calling for the buyer or seller to perform some activity which **must occur**. If the activity does not occur, the purchase agreement has been breached by the person who promised to perform or was obligated to cause the activity or event to come about.

   Examples include the failure of the seller to produce promised information, data, documents and reports on the property or deliver a clearance, grant deed or title insurance policy as agreed. The failure to deliver is a breach which allows the other person to either terminate the transaction by notice of cancellation and recover his money losses or pursue specific performance of the purchase agreement.

Before escrow can proceed on to closing, contingency provisions must be eliminated. Contingency provisions (conditions precedent) included in purchase agreements are eliminated by either:

- satisfaction of the condition by either an approval of the data, information, documents or reports identified as the subject of the provision by the person holding the right to terminate the transaction, or by the occurrence of the event called for in the provision; or

- waiver (or expiration) of the right to cancel the transaction by the person authorized to cancel, if the identified condition or event has not been satisfied by its approval or occurrence.

Thus, the buyer or seller who does not have the right to terminate the transaction under a provision and avoid closing the transaction must perform all his remaining obligations on the contract, called conditions concurrent.

He must act without concern for the other person's performance under the purchase agreement, unless the other person must first perform some activity before he is able to comply. For example, the seller providing a Natural Hazard Report before the buyer can review it and approve its contents. [See **first tuesday** Form 150]

The obligation of a buyer or seller to complete noncontingent (concurrent) activities required of him to close escrow exists in spite of the fact the other person may not have yet fully performed,

or that the other person has a right to later cancel the purchase agreement. Examples include the inability of a buyer to originate a purchase-assist loan (or cancel) after the seller has fully performed by delivering all closing documents to escrow.

**Content of a contingency provision**

Regardless of the type of contingency involved, agents must make sure the contingency provision is in writing, even though oral contingencies are generally enforceable. Written contingencies avoid confusion over content, enforceability and forgetfulness.

Specifically, the content of a written contingency should include:

- a description of the event addressed in the contingency (i.e., what is to be approved or verified);
- the time period in which the event called for in the contingency provision must occur;
- who has the right to cancel the purchase agreement if the event does not occur (i.e., whether the buyer, the seller, or both, can enforce the contingency provision by canceling the transaction);
- any arrangements to avoid cancellation if the contingency is not satisfied or waived (i.e., offsets to the price or time to cure the failure or defect); and
- the method for service of the notice of cancellation on the other person.

**Provisions for uncertainties**

An agent includes contingency provisions in a purchase agreement in an effort to protect his client from agreeing absolutely to do or cause to occur that which may not occur. The goal at closing is to avoid being forced to accept a situation inconsistent with the client's original expectations or ability to perform when he entered into the purchase agreement.

Without *authority to terminate* the agreement on the failure of the client's expectations, such as the buyer's inability to record a purchase-assist loan or to confirm the seller's representations, the client's inability or refusal to continue to further perform under the purchase agreement and close escrow would be a breach. Thus, the client due to his breach would be liable to the other person, unless the client's nonperformance was justified by some pre-contract misrepresentation (or omission) of facts which led to the client's lost expectations, called deceit.

To avoid a *breach or be excused* from closing escrow, an exit strategy must be agreed to in the purchase agreement. When events and conditions develop which do not meet the expectations or anticipations of the client during escrow, his agent must have foreseen the need to conditionalize the client's continued performance by including contingency provisions in the purchase agreement. [See **first tuesday** Form 159]

But before lacing a purchase agreement with contingency provisions, or allowing the client to enter into one, a prudent agent will first attempt to gather information and clear uncertainties the client may have about the property or the transaction before entering into the contract.

**Use of contingency provisions**

It is the buyer's agent who, along with buyers, is the primary user of contingency provisions in purchase agreements. From a buyer's point of view, and thus the buyer's agent's perspective, every activity, event or condition which is the responsibility of the buyer to further investigate and approve or cause to occur prior to closing should be the subject of a contingency provision in the purchase agreement. [See **first tuesday** Forms 260 through 279]

Also for buyers, the period for exercise of the right to cancel should be as long as possible. Thus, the right to cancel should be structured to expire no earlier than the date scheduled for the close of escrow. The possibility always exists that the event or approval needed by the buyer to close escrow may never occur.

These conditions range, for example, from applying for purchase-assist financing or retaining consultants for advice on the value or integrity of the property, to making the down payment or providing personal identity information to the title insurance company.

When preparing the purchase agreement, the buyer's agent must rely on his experience to decide which events and approvals the buyer is responsible for and thus need to be the subject matter of a contingency provision.

Then, if the event does not occur, such as the recording of mortgage financing, or are unacceptable, such as the failure of the property on a due diligence investigation to meet expectations, the buyer may cancel and be excused from proceeding. Thus, he can act to avoid closing and not be in default (breach) on the purchase agreement (or end up in a dispute claiming he has been misled by the seller or the seller's agent).

Many events and disclosures are the subject of contingency provisions contained in stock forms used by agents. [See Form 159 §11]

However, the boilerplate wording used by different publishers of pre-printed contingency provisions varies greatly regarding:

- the time for gathering and delivering data, information, documents and reports;
- the time period for review of the material received or the occurrence of an event (such as a loan commitment or sale of other property);
- the date set for expiration of the right to cancel the transaction after failure of the event or approval to occur;
- whether a written waiver is to be delivered evidencing the elimination of the contingency provision, without which the other party may then cancel;

- the requirement of a written notice of cancellation should the right to cancel be exercised on failure of an event or condition; and

- the time period for the other person's response to a notice of cancellation to cure the defect or failure, and thus avoid a termination of the purchase agreement.

Typically, several contingency provisions are included in a purchase agreement. Thus, a *uniform method* for terminating the agreement is employed. Termination provisions call for a written notice of cancellation, and how and to whom it is to be delivered, including instructions to escrow. [See Form 150 §10.5]

Also, approval notices or waiver of contingency provisions need not be called for in purchase agreements.

Contingency provisions are considered to be the grant of an option to terminate a transaction by exercise of the right to cancel prior to the expiration of the option period.

The person authorized to cancel or otherwise benefit from a contingency provision, who does not use the provision to cancel the purchase agreement need do nothing. He simply allows the "option period" for cancellation to expire.

A need does not exists to approve or waive the contingency in order to do away with the right to cancel and proceed to close escrow, unless the purchase agreement wording states an approval or waiver is required to keep the contract alive. [**Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49]

**Conditions not contingent**

The condition of the property, namely the physical integrity of the land and improvements, is frequently not disclosed to the buyer before entering into a purchase agreement. Most delayed disclosures fail to comply with the statutory mandates imposed on sellers and seller's agents to hand the information to prospective buyers as soon as reasonably possible (ASAP). [Calif. Civil Code §§2079 et seq.; Calif. Attorney General Opinion 01-406 (August 24, 2001)]

The seller's agent has a mandated duty, owed to the public, to visually inspect the listed property and note his observations and awareness of property conditions adversely affecting the value on the seller's statutory disclosure document, called a Condition of Property or Transfer Disclosure Statement (TDS).

Not only is it reasonably possible for the seller's agent to deliver the TDS before his seller enters into a purchase agreement with a buyer, it is mandated by **case law** and the economic imperative of transparency to deliver property disclosures before a price is set in property transactions. Without prior disclosure, the placing of the property under contract is corrupted due to asymmetric knowledge of property facts by the buyer and seller. That corruption is due to the seller's agent's failure to deliver the TDS to the prospective buyer before an acceptance.

However, **trade union purchase agreement forms** convert the failure of the seller's agent to deliver a TDS before the acceptance of an offer into an unavoidable contingency, which

complies with the statutorily imposed penalty placed on the seller for failure of pre-acceptance disclosures. As the subject matter of a contingency, the buyer is granted the right to cancel the transaction when the TDS is belatedly received.

If on review of the tardy disclosures the property conditions do not meet the expectations held by the buyer at the time he entered into the purchase agreement, *the buyer may cancel* the purchase agreement — all due to the dilatory and misleading conduct of the seller's agent, a type of fraud called deceit.

However, if the buyer chooses not to cancel as provided him by the contingency, the buyer can close escrow. Thus, he becomes the owner of property which is not in the condition and of the value he was lead to believe existed when he entered into the purchase agreement, the result of misrepresentation by omission of facts on the part of the seller or one or more agents. This situation exposes the listing broker to liability for the lost value.

Now applying the same disclosure of facts, consider a diametrically opposed and buyer protective purchase agreement provision written to handle the seller's agent's dilatory delivery of the TDS. The provision does not establish a contingency by attempting to limit the rights of the buyer to cancellation on discovery of defects. State codes automatically provide such remedy without a written provision.

Rather, the TDS disclosure provisions call for the buyer to review the seller's and seller's agent's post-acceptance property disclosures. The provision grants no one the authority to cancel should the property's conditions be unacceptable or less than expected when entering into the purchase agreement. Instead, it **requires continued performance by all** so that escrow will close as though the property disclosure had taken place before an acceptance of an offer to buy as mandated by legislation.

Any significant discrepancies in the property's condition disclosed in the TDS and not observed or known to the buyer before entering into the purchase agreement allows the buyer to notify the seller of the defects and make a demand on the seller to cure them by repair, replacement or correction. If the buyer fails to give notice, he has let his right expire to demand the correction of previously undisclosed defects noted in the untimely TDS and must now proceed to close escrow. [See **first tuesday** Form 269]

However, if the buyer makes a demand on the seller to cure those defects first discovered by the buyer on his in-escrow review of the tardy TDS, the seller is required to make the corrections before closing or suffer a reduction in the price equivalent to the cost to cure the noticed defects. Of course, the disclosure of the property's condition before the purchase agreement (or counteroffer) is accepted relieves the seller (and the buyer) of the need to activate this performance provision regarding repairs. [See Form 150 §11.2]

The time set for delivery of data, information, documents and reports under a contingency provision for approval or disapproval, as well as the date set for delivery of a notice of cancellation given for any valid reason, is always subject to time-essence rules. These rules are liberally enforced to meet the closing objectives of the buyer and seller. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

**Unless delivered and until satisfied**

Frequently, a contingency provision calls for two events to occur in tandem, i.e., a condition concurrent (routine activities), which must occur, followed by a condition precedent (approval), which may or may not occur.

For example, a seller of a condominium unit first provides documents on the homeowners' association (HOA) to the buyer (the condition concurrent) for what then becomes the buyer's review (the **condition precedent**). Here, the seller must deliver the HOA documents as a prerequisite to the buyer's review of their content for approval or disapproval. The seller must obtain the documents or otherwise cause them to be handed to the buyer. If he does not, the seller has breached the contingency provision and the purchase agreement. [See Form 150 §11.9]

As for the buyer who receives the HOA documents, he must then enter upon a good-faith review of the document's content under his further-approval contingency provision. After the review and completion of any further inquiry or investigation into the implications contained in the HOA document's content, the buyer is to either express his approval by waiving or letting the right to cancel expire. However, if he has good reason and an honest belief that he cannot approve of their content, he disapproves the documents by canceling the transaction.

Here, the seller is initially obligated to gather the documents and deliver them to the buyer without concern for what steps the buyer may or may not be taking to perform any of his obligations under the purchase agreement, such as applying for a loan, providing a credit report or approving disclosures he has received.

Consider another tandem-events provision in which the buyer agrees to execute a **promissory note** in favor of the seller in a carryback transaction. The buyer, in a further-approval contingency provision, agrees to prepare and hand the seller a credit application. On receipt, the seller is to review and then approve or cancel the transaction, if the seller has a reasonable basis for disapproving the buyer's creditworthiness.

The buyer's obligation to deliver the credit application is a compulsory event he is required to perform. The failure to deliver the credit application is a breach of the further-approval provision since the buyer's delivery of the application is not conditioned on anyone (read: the seller) first doing something. [See Form 150 §8.4]

On the other hand, the seller on receipt of the credit application is required to review the buyer's creditworthiness.

However, he is not required to approve the buyer's creditworthiness, and if disapproved based on reasonable grounds, the seller is excused from closing escrow if he elects to cancel the transaction. [See **first tuesday** Form 150 §8.5]

**Act to close without concern**

Other contingency provisions require one person, such as the buyer, to first enter upon an activity (such as signing and returning escrow instructions) without concern for whether the other person, such as the seller, is performing his required obligations, such as obtaining a pest control clearance, an occupancy certificate, the release or reconveyance of liens on title, etc.

For example, a purchase agreement contains a contingency provision calling for the buyer to obtain and record a purchase-assist loan. Should the buyer fail to originate the loan as anticipated, the buyer may cancel the transaction, excusing himself from further performing.

However, the buyer is obligated to promptly initiate the loan application process without concern for whether the seller has commenced any performance of the seller's obligations, such as signing and returning the seller's escrow instructions, providing a deed or ordering out inspections and reports the seller is required to obtain. [**Landis** v. **Blomquist** (1967) 257 CA2d 533]

A person's performance of an activity which **must occur** versus his taking steps to bring about an event or approve a condition which may or may not occur is an important distinction to be made. One is a breach of the purchase agreement should the mandatory activity not occur; the other excuses any further performance by cancellation should the described event not occur. Both failures permit the purchase agreement to be canceled by the opposing party, but a breach carries with it *litigation and liability exposure*.

For example, the buyer of a nonresidential income property is willing to purchase the property only if the seller cancels a disadvantageous lease held by a tenant. The buyer's agent prepares a purchase agreement with a provision calling for the seller to deliver title and assign all existing leases except the one the buyer is unwilling to accept.

While the seller believes he can negotiate a cancellation of the lease, the seller's agent does not want his seller committed to delivering title and then fail to be able to negotiate the cancellation of the lease.

To accept the purchase agreement with provisions calling for delivery of title clear of the lease would place the seller in breach if he is unable to negotiate a cancellation of the lease. The seller would be exposed to liability for the decrease in the value of the property resulting from the lease remaining as a defect (i.e., an unapproved encumbrance) on the title.

Here, the seller should submit a counteroffer prepared by the seller's agent calling for the delivery of title to be contingent on the seller's termination of the lease, an **event-occurrence contingency provision**.

Thus, the seller will only become obligated to make a good-faith effort to negotiate the cancellation of the lease. Should he fail to be able to deliver title clear of the lease, he may cancel the transaction and be excused from any further performance, and, importantly, be free of any liability for the failure to deliver title as agreed.

**Performing without concern**

Many contingency provisions authorize the buyer to exercise his right to cancel at any time up to and including the date scheduled for closing should an identified condition or event fail to occur. In the interim, the seller must fully perform all of his obligations to deliver to escrow all documents needed from the seller for escrow to close. After the seller has fully performed, the buyer, at the time of closing, may then cancel on failure of the condition or event.

The **rights of a seller** in the buyer's contingency provision include assurances that:

- the buyer must act on any cancellation before *the right to cancel expires*; and
- the cancellation is the result of a good-faith effort by the buyer to act reasonably to *satisfy the contingency* so the transaction can close.

Consider a purchase agreement with terms for the payment of the purchase price which include having the buyer obtain a purchase-assist loan. The close of escrow is contingent on the buyer recording the loan since the buyer has the right to cancel if payment of the price cannot be funded by a purchase-assist loan. [See Form 150 §10.3]

However, the seller has not handed escrow any of the documents or information requested by escrow, the receipt of which is needed to close escrow. The buyer then refuses to submit his loan application and fees to his lender until the seller has fully performed all his obligations for escrow to close. The buyer claims it is futile for him to proceed if the seller has not performed.

In turn, the seller cancels the transaction, claiming the buyer has breached his duty to make a good-faith effort to eliminate the loan contingency by applying for the loan.

Here, the buyer's obligation to take steps to satisfy the loan contingency and the seller's obligation to deliver deeds, termite clearances, etc. to escrow are independent obligations, called conditions concurrent. Thus, the buyer and seller must each perform their part of the closing activities without concern for whether the other person has or is performing.

Also, the seller must, prior to the date scheduled for close of escrow, have fully performed all the acts required of the seller for escrow to close, and perform them at a time sufficient for escrow to close on the date scheduled. The seller must comply even though the buyer's right to terminate the transaction can be exercised by canceling the escrow as late as the date scheduled for closing. [Landis, *supra*]

Sellers who agree to loan contingency provisions for buyers often require a separate and specific time-essence contingency provision to assure themselves that the buyer will act promptly to arrange a loan. In the provision, the buyer authorizes the seller to cancel the transaction if the buyer does not produce a loan commitment or a statement from a qualified lender by a specific date demonstrating that the buyer has been approved for a loan in the amount sought. [See Form 150 §4.1]

Now, if the buyer fails to timely act on an application to negotiate a loan and arrange for a statement of his creditworthiness to be handed to the seller by the deadline for satisfaction of the condition, the seller may cancel the transaction.

**Purchase agreement as binding**

The existence of an oral or written contingency provision in a purchase agreement does not render the agreement void, as though it were a mere illusory contract which never was binding.

On the contrary, when an offer is accepted, a binding agreement is formed. The overriding issue on forming a binding purchase agreement which contains a contingency provision is whether the purchase agreement will ever **become enforceable** by the elimination of contingencies as satisfied or waived.

For example, the board of directors of a corporation decides the company needs to purchase a warehouse to store inventory. To meet the corporate objectives, the president, on behalf of his corporation, employs a broker who locates a suitable building. It appears the property will be sold to another person before board approval can be obtained authorizing the corporation to enter into a purchase agreement to acquire it.

As the agent authorized to bind the corporation to perform under a purchase agreement, the president, on behalf of the corporation, submits a signed purchase agreement offer to the seller's agent agreeing to buy the real estate, conditioned on the further approval of the board of directors within 20 days of acceptance.

The seller accepts the offer after his seller's agent explains the purchase agreement will not be enforceable until the board of directors approves the purchase, and thus eliminates the contingency.

The corporation, based on the offer submitted by its president and the seller's acceptance, has effectively taken the seller's property off the market while the president completes his due diligence investigation. Further, the board gets a "free look" by controlling the property before deciding on the property's suitability as a warehouse, or whether the terms of the purchase agreement are acceptable.

Here, the seller has a binding commitment from the corporate buyer to purchase the real estate, subject to presenting the purchase agreement and the property selection to the board for approval or rejection and cancellation under the contingency provision. [**Moreland Development Company** v. **Gladstone Holmes, Inc.** (1982) 135 CA3d 973]

However, the officers and board of directors of any corporate buyer or seller must act in good faith when exercising a contingency provision by cancellation. Accordingly, the officers need to submit the purchase agreement transaction to the board. The board then needs to review the purchase agreement. If conditions are unacceptable, the board rejects the purchase agreement by preparing a resolution stating their reasonable basis for exercising the corporation's rights under the contingency provision to disapprove of the property selection or the terms of purchase. A notice of cancellation is then prepared, signed and delivered to the seller, together with the corporate resolution, as required by the purchase agreement to terminate the transaction. [**Jacobs** v. **Freeman** (1980) 104 CA3d 177]

# Chapter 7 — Arbitration: the independent beast

*This chapter presents the adverse impacts created by agreeing to a binding arbitration clause in a real estate listing or purchase agreement.*



***Chapter 7 Terms***

| | |
|---|---|
| *Binding arbitration* | *Mediation* |
| *Erroneous award* | *Third party loophole* |
| *Judicial review* | *Vicarious liability* |

## Lost right to correct a decision gone awry

The trend regarding dispute resolution encouraged by trade unions, arbitration associations and the courts since 1978, has been to avoid the California court system by agreeing to resolve disputes involving the purchase or leasing of real estate and agency relationships through *binding arbitration*. Today, the wisdom of this trend in real estate related contracts is under increasing attack, and *mediation* which is the antithesis of arbitration had become the strong man of dispute resolutions.

Many pre-printed brokerage and purchase agreements perfunctorily include a boilerplate **arbitration provision**. The arbitration provision included in a purchase agreement, listing or lease agreement **forms a contract** with an arbitrator. Thus, the provision forms an independent agreement between the person who initials the provision and the arbitrator, an agreement separate from the purchase agreement which contains the provision. [**Prima Paint Corporation** v. **Flood & Conklin Mfg. Co.** (1967) 388 US 395]

To be enforceable in sales of one-to-four unit residential property, the arbitration provision must include a 165 word warning about the lost rights of *judicial review* and be initialed by the person against whom the provision is to be enforced. Thus, an arbitration provision is enforceable against any person who initials the provision, even if that person is the only one to initial it. [**Grubb & Ellis Company** v. **Bello** (1993) 19 CA4th 231]

*Editor's note — first tuesday's purchase agreements and addenda do not contain either an arbitration provision or an attorney fee provision as a matter of policy in an concerted effort to reduce the risk of litigation to brokers and agents by making litigation less economically feasible for sellers and buyers — and their attorneys.*

An arbitration provision in a real estate purchase agreement, listing or lease:

- is an arbitration agreement between the arbitrator and each person who agrees to be bound by the provision [Calif. Code of Civil Procedure §1297.71]; and
- defines the arbitrator's powers and the limitations on those powers.

The rights of the person agreeing to arbitration are established by the incorporation in the provision of arbitration statutes, applicable law limitations and discovery policies. Also controlling are the rules adopted by the arbitrator named in the provision, such as the American Arbitration Association.

Unless the arbitration provision states an arbitration award is "subject to judicial review," the award resulting from arbitration brought under the clause is **binding and final**. Without **judicial review** of an award in an arbitration action, the parties cannot be assured the award will be either fair or correct. Other defects regarding gathering information for trial exist, called discovery.

**Arbitration's hype**

Arbitration proceedings are reputed to be swifter and less costly than trials. Also, arbitrating disputes rather than litigating them eases the burden on the court system, and thus the taxpayer. Further, a public airing of "dirty laundry" produced in court filings and proceedings is avoided.

However, arbitration does not much live up to its reputation for being inexpensive or expedient. Filing fees for arbitration are high compared to filing fees for litigation. Unlike judges who are paid by the taxpayer, the arbitrator's charges must be paid by the loser. Additionally, the winner's attorney fees are paid by the loser when an attorney fee provision exists in the purchase agreement, lease or listing agreement involved. Nothing saved here as the expense of arbitration is higher.

Arbitration proceedings draw out for years when the dispute becomes complicated, just as in litigation. Also, a legitimate disagreement with the arbitrator's award as inconsistent with controlling California law, when called for in the powers granted the arbitrator by the arbitration provision, frequently leads to litigation in an effort to get the result attainable had the action been filed in a court of law in the first place.

**Bizarre results not correctable**

Consider a seller who contacts a brokerage office to list his property for sale. The sales activity is delegated to the broker's agent who procured the listing, customarily called the *listing agent*.

The seller and seller's agent sign a listing agreement containing a provision calling for disputes to be submitted to **binding arbitration** — no judicial oversight permitted.

A buyer is located and an offer is obtained by another agent employed by the same broker, customarily called the *selling agent*. Both the agents and the broker are aware the buyer is financially unstable and may encounter difficulties closing the transaction.

However, confirmation of the buyer's creditworthiness and net worth are not made the subject of a contingency provision by the buyer's agent who prepared the offer for the buyer. A contingency would have authorized the seller to cancel the purchase agreement had the seller decided the buyer's credit was for him unsatisfactory.

When the seller's agent, acting alone, submits the buyer's offer to the seller, the buyer's financial status is not discussed or disclosed, orally or in writing. The supervising broker fails to catch or correct the oversight.

The seller accepts the purchase agreement offer which provides for payment of a fee to the broker. Each agent will receive a share of any fee their broker may receive on the sale. Each agent's share is based on formulas agreed to in their respective written employment agreements with the broker a mandated.

Later, the buyer fails to close the transaction due to his disabling financial condition. The seller discovers that the seller's agent, broker and buyer's agent all knew of the buyer's financial condition and failed to advise him of this fact. The seller makes a demand on the broker and both agents for his losses on the failed transaction, claiming the buyer's financial condition was a material fact in the transaction which the agents and broker knew about and failed to disclose.

The dispute is submitted to binding arbitration which the broker did not contest to based on his not being a party to the contract.

The arbitrator awards money damages to the seller based on the professional misconduct of the seller's agent and employing broker for failure to disclose their knowledge of the buyer's unstable financial status — the broker being **vicariously liable** as the employer of the seller's agent who failed to make the disclosure.

Further, the arbitrator issues the seller an erroneous money award against the buyer's agent ruling the buyer's agent and the seller's agent were "partners" since they would share in the fee the broker was to receive on the transaction. Thus, the buyer's agent is improperly held liable as a partner of the seller's agent for the seller's money damages resulting from the misconduct of the seller's agent.

The buyer's agent then seeks to vacate the portion of the arbitration award holding him liable as a "partner" of the seller's agent, claiming the arbitrator incorrectly applied partnership law to a real estate agency and employment relationship.

Can the award against the buyer's agent be corrected by a court since the arbitrator wrongfully applied partnership and agency law?

No! An arbitrator's award, based on an erroneous application of law, is not subject to **judicial review** since a judicial review of the arbitrator's award was not included as a condition of an award in the arbitration provision. The arbitrator acted within his powers granted by the arbitration provision, even though he applied the wrong law and produced an erroneous result.

A court of law confronted with a binding arbitration agreement cannot review the arbitrator's award for errors of fact or law even if the error is obvious and causes substantial injustice. [**Hall** v. **Superior Court** (1993) 18 CA4th 427]

### Grounds for correction

Any defect in an arbitrator's award resulting from an error of fact or law, no matter how flagrant, is neither reviewable nor correctable, unless:

- the arbitrator exceeded his authorized powers;
- the arbitrator acted with fraud or corruption;
- the arbitrator failed to disclose grounds for his disqualification;
- the award was procured by corruption, fraud or other misconduct; or
- the refusal of the arbitrators to postpone the hearing substantially prejudiced the rights of the party. [CCP §1286.2]

An arbitrator, unlike a judge in a court of law, is not bound by the rules of law when arbitrating a dispute. Even when the arbitrator agrees to follow applicable California law, his *erroneous award*, unlike an award of a court, cannot be corrected by any judicial review. The arbitrator's award is final and binding on all parties, unless:

the parties have agreed the arbitrator's award is subject to "judicial review;" or

the arbitrator applied the wrong law and in so doing exceeded his powers which had been limited to applicable law by the arbitration provision.

Otherwise, no judicial oversight exists, by petition or appeal, to correct an arbitrator's **erroneous award**.

**The capricious arbitrator's award**

Consider a buyer and seller of real estate who enter into a purchase agreement on a form which contains an arbitration clause. They both initial the provision.

Prior to closing, the seller discovers the property has significantly greater value than the price the buyer has agreed to pay in the purchase agreement, a condition brought about by a sharply rising real estate market.

Motivated by his belief the property's value will continue to rise to price levels other buyers will be willing to pay, the seller refuses to close the sale.

The buyer files a "demand for arbitration" with the arbitrator, claiming the seller breached the purchase agreement. The buyer seeks only to recover his **money losses** amounting primarily to the difference between the purchase price he agreed to pay for the property and the increased value of the property on the date of the seller's breach, called money damages, to which he is entitled by law.

The buyer no longer wants the property and does not seek his alternative remedy of specific performance of the purchase agreement, even though the seller still owns the property.

Prior to completion of the arbitration hearings, the value of the property drops significantly due to a cyclical local economic downturn. The arbitrator is aware the property's current value has fallen below the sales price agreed to in the purchase agreement as well as the increased value at the time of the seller's breach.

The arbitrator then issues an award in favor of the buyer. However, the award is not for the money losses the buyer was entitled to. Instead of the requested money award, the arbitrator's award grants the buyer the **right to purchase** the property for a price equal to its current fair market value, a remedy not available under the law.

The buyer now petitions the court to vacate the arbitration award and remand the case for a money award as requested in the arbitration. The buyer claims the arbitrator exceeded his powers by awarding a result not contemplated by the law controlling the purchase agreement nor sought by the parties, i.e., the right to acquire the property at a different price even though the buyer no longer wants to acquire the property.

Did the arbitrator exceed his powers, act corruptly or prejudice the rights of the parties by awarding an equitable remedy (specific performance) which was in absolute conflict with the purchase agreement (different price) and beyond any expectations of either the buyer or the seller under applicable law?

No! The arbitrator was not corrupt and did not exceed his powers in awarding the buyer the right to purchase the property at its current market value. The erroneous award was drawn from the arbitrator's (mis)interpretation of the purchase agreement and the law.

Basically, the remedy awarded a buyer by an arbitrator in binding arbitration is not reviewable by a court of law, as long as the remedy has "some remotely conceivable relationship" to the contract. [**Advanced Micro Devices, Inc.** v. **Intel Corporation** (1994) 9 C4th 362]

When individuals enter into a purchase agreement, each person has expectations about his and the other person's performance as defined by the terms of the agreement and set by existing law, also known as certainty of contract. Without certainty in the real estate market, contracting to buy and sell becomes a commercial uncertainty, which is tantamount to anarchy.

Yet by agreeing in the purchase agreement to binding arbitration, not only is a person forced to accept an arbitrator's incorrect application of law, he is forced to proceed with arbitration and accept an award **impossible to predict**.

As the dissent in Advanced Micro Devices, Inc. points out, a bizarre interpretation by an arbitrator of the agreement underlying a dispute, coupled with a blatant error of law, might result in an arbitration award "ordering the marriage of the disputing parties' first-born children."

An arbitrator has great latitude in making decisions since he may use his own discretion and does not need to follow the mandates of the regulations, case decisions and codes upon which the contractual dispute rests.

**Arbitrator's authority to enforce his award**

Consider two partners in a real estate venture whose partnership agreement contains a boilerplate arbitration clause stating any dispute arising out of the agreement will be submitted to binding arbitration without judicial review.

On dissolution of the partnership, a dispute arises regarding disposition of the property, which is arbitrated. On issuing the award, the arbitrator includes the appointment of a receiver to supervise the sale of the partnership's property, rather than an award limited to calling for the property to be sold.

One of the partners seeks to vacate the arbitration award claiming the arbitrator exceeded his powers by appointing a receiver to sell the partnership's property.

Did the arbitrator exceed his powers by appointing a receiver to **enforce his award**?

Yes! The portion of the arbitration award appointing the receiver is invalid. An arbitrator lacks authority to enforce his award for the sale of the property, which is what the appointment of a court appointed receiver is designed to do.

The arbitration award must first be reduced to a **court-ordered judgment** before enforcement under the judgment entered by the court. On issuing an award, the person receiving the award files a petition with the court to confirm the award. On confirmation at a hearing on the petition, judgment is entered in conformance with the award.

It is the judgment which is enforced, not the arbitrator's award.

Although an arbitrator is not bound to follow the law when issuing an award, an arbitrator exceeds his powers when he attempts to also enforce his award — conduct reserved for a court of law after the award has been reduced to a judgment by the court. [**Marsch** v. **Williams** (1994) 23 CA4th 238]

An arbitrator also **exceeds his powers** when he imposes fines on a party to arbitration for failure to comply with the arbitration award. An arbitrator does not have the power to impose **economic sanctions**, such as penalties and fines.

However, had the arbitration agreement authorized the arbitrator to appoint a receiver or impose fines, the arbitrator then has the power to do so, despite the general prohibition barring arbitrators from enforcing their awards. [**Mastrobuono** v. **Shearson Lehman Hutton, Inc.** (1995) 514 US 52]

**Attorney fees as a power**

Now consider a buyer and seller who enter into a real estate purchase agreement containing both an arbitration provision, which they all initial, and an attorney fee provision. The attorney fee provision entitles the buyer or seller who prevails in an action to be awarded his attorney fees.

The buyer terminates the purchase agreement and seeks to recover all his transactional costs, claiming the seller has breached the agreement. As agreed, the dispute is submitted to binding arbitration. The arbitrator rules in favor of the seller, but denies the seller's request for attorney fees as called for under the attorney fee provision in the purchase agreement.

The seller seeks a correction of the arbitration award in a court of law claiming the arbitrator exceeded his powers by denying an award of attorney fees as agreed in the purchase agreement.

Here, the arbitrator did exceed his powers by failing to award attorney fees. The seller as the prevailing party was entitled to an award of attorney fees by a provision in the purchase agreement which was the subject of the arbitration. If the agreement underlying the dispute contains an attorney fee provision, the arbitrator must award attorney fees to the prevailing party. [**DiMarco** v. **Chaney** (1995) 31 CA4th 1809]

The attorney fee dilemma has a flip side. Not only must the arbitrator award attorney fees to the winner if the recovery of fees is called for in the purchase agreement, the arbitrator must determine the amount of the attorney fees to be awarded, an amount which is not subject to court review. [DiMarco, *supra*]

**Avoiding arbitration**

Consider a broker or agent who becomes a member of a local trade association. As part of the membership agreement, he agrees to binding arbitration for disputes arising between him and other association members.

The arbitration panel that hears and decides disputes between members is composed of other members of the local association who have little to no legal training.

These local arbitration panels frequently base their decisions on moral or social beliefs and local customs they have personally adopted, rather than on controlling legal principles. Preference and bias towards a particular member of the association is more likely since the members of the arbitration panel are acquainted with or know about the members involved in the dispute. Yet, these panels are to consist of "**neutral**" arbitrators.

The panels are also very much aware the decisions they render are not appealable or reversible. Their award is final and binding.

However, the primary problem with arbitration proceedings heard by a local association's arbitration panel is the feeling held by most brokers and agents who are compelled to arbitrate that they are being railroaded through a process that disregards their rights, whether or not they are violated.

Further, by becoming a member of a local trade association, brokers and agents are forced to relinquish their rights to a court trial and an appeal to correct an erroneous decision rendered in disputes with other members.

However, brokers and agents employed by a broker who is an association member can avoid the complications imposed on them by membership. To do so and still comply with their broker's desire to satisfy the local trade association's annual monetary demands arising out of their association with the broker, they can pay the same amount in "nonmember dues" and become "paid nonmembers." [**Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920]

**Third party loophole**

Consider a buyer of real estate who enters into a purchase agreement with a seller of a single family residence (SFR).

A trade union purchase agreement form is used, which contains a boilerplate binding arbitration provision. Both the buyer and the seller sign the purchase agreement and initial the arbitration provision, thus committing both parties to resolve any disputes that may arise through binding arbitration.

After escrow is opened on the sale, the seller deeds his property to his broker. Thus, the seller's broker becomes the substitute seller by assignment. Upon assignment of the seller's sales rights under the purchase agreement, the seller's broker assumes all responsibilities and commitments set forth in the original purchase agreement as signed by the buyer and the original seller.

A dispute arises over payments on the carryback note executed by the buyer, and the seller's broker begins foreclosure proceedings against the property.

The buyer then discovers he did not purchase the property from the original seller, but in fact purchased the property and was making payments on the carryback note to the seller's broker, who he claims is misappropriating his payment funds.

The buyer files a lawsuit against the seller's broker, the original seller and the buyer's broker.

The seller's broker seeks to compel arbitration pursuant to the arbitration provision in the trade union purchase agreement used for the transaction.

The buyer refuses to arbitrate, claiming the arbitration provision in the purchase agreement is **unenforceable** since the buyer's broker, who the buyer is suing in addition to the seller and the seller's broker, is not a party to the arbitration provision.

Can the buyer avoid arbitration and proceed with litigation since there is a third party involved in the dispute who is not subject to the arbitration provision?

Yes! The buyer named multiple parties in his lawsuit, at least one of which was not a party to the contract – purchase agreement – which contained the arbitration provision, thus providing a *third party loophole* for the buyer to avoid adverse results in arbitration.

The seller's broker became the **substitute seller** when the seller assigned his selling rights (transferred deed) to his broker. Thus, the seller's broker is a party to the agreement containing the arbitration provision since he assumed all rights and responsibilities of the seller under the original purchase agreement.

However, when the buyer's lawsuit includes a third party (the buyer's broker) who is not a party to the purchase agreement containing the enforceable arbitration provision, in a dispute arising out of the same transaction or series of related transactions, the buyer avoids arbitration's consequences entirely since the court will deny arbitration and join all parties in a single action to be adjudicated in court. This effectively renders the arbitration clause useless in the hands of competent counsel by simply dragging the brokers into the dispute. [**Valencia** v. **Smyth** (2010) 185 CA4th 153; CCP § 1281.2]

**There is no benefit, there is no bargain**

Given the fact an arbitrator's erroneous conclusions are not correctable, this flaw is considered part of the **benefit of the bargain** to arbitrate, a condition inherent to the process of arbitration.

Principals in a real estate transaction who negotiate to include an arbitration provision in a contract are presumed to be fully aware of the risks they take on when agreeing to settle any disputes through arbitration.

Thus, in exchange for the purported lower cost, quicker result and overall convenience of arbitration versus litigation, disputants are supposed to knowingly accept the possibility an arbitrator may err in his judgment on the facts and law and such an error may not be reviewed or corrected. [**Hoso Foods, Inc.** v. **Columbus Club, Inc.** (2010) 190 CA4th 881]

Ideally, all real estate brokers and agents who use the standard trade union purchase agreement form fully apprise their clients of the myriad hazards presented by arbitration. Were this advice the norm, the presumption that the bargain is necessarily considered when a client initials and agrees to arbitrate would be fair.

However, given the predominance of the dumb agent rule practiced by most brokers employing several to hundreds of agnets, and the unfortunate widespread misconception that the explanation of a contract prepared by an agent or broker is somehow the unauthorized practice of law, most agents deliberately refrain from informing their client that agreeing to binding arbitration means signing away their right to fair and final decision subject to judicial review — this assumes, of course, that the agent is aware of the risks, which many are not.

Thus, clients in real estate transactions are not counseled when deciding to agree to arbitration. Rather, it is assumed the provision, along with the myriad others, will be quickly initialed and the "bargain" therefore is made blindly. Binding arbitration becomes an obligation of only the clients that initial the provision and necessarily denies the client recourse in the event the arbitrator errs, which is an inevitable and uncorrectable occurrence of benefits denied.

**Mediation**

Instead of immediately resorting to the costly and adversarial process of either type of action, be it arbitration or litigation, in recent years the trends in real estate sales indicate disputants (and society) favor the use of **mediation**.

Many listing and purchase agreements contain binding arbitration agreements as an alternative action to litigation. [See **first tuesday** Form 150]

However, arbitration is final and unappealable since in trade union forms it is binding without **judicial review**. Thus, arbitration is a double-edged sword as disputants have no assurance the arbitrator's award will be fair or correct. Only with mediation's familiar arena of offer and counteroffer between the feuding parties, as encouraged by the mediator, do they have the ability to come to a mutually crafted and agreed-to solution, the main psychological advantage mediation has over actions in litigation or arbitration.

Litigation is, at its heart, a deeply adversarial process which ends with a spurned "loser" who can then move on to draw out the dispute in a time-consuming and costly appeals process. Arbitration functions as a substitute but similar action, shunting the disputants into "winner" and "loser" roles, with feet set in concrete. In arbitration, all the power of the decision is placed upon the arbitrator. Even if the arbitrator bases his decision on an incorrect interpretation of the facts or the law, neither party has recourse to change the erroneous decision. [Hall, *supra*]

The extremely low cost of **mediation** has been deemed another major benefit of the process. Consider as part of the cost the time involved in mediation versus the time involved in litigation or arbitration. Litigation can be drawn out for years with various pre-trail, discovery, and appeal processes, all while the attorney's billable hours soar. Arbitration may also last years and in addition to contracted-for attorney fees, the loser is responsible for paying the arbitrator's costs and fees.

However, mediation is typically a quick process lasting a few hours to a few weeks, depending on the number of disputants and the complexity of the dispute. There are no lengthy waits for court hearings or the need for witnesses since the resolution is in the hands of the disputants themselves, again as encouraged and moved along by the mediator.

In addition to these benefits, the use of mediation also provides a solution to a dispute without adding to and falling subject to the backlog of cases burdening the legal system.

Most importantly, mediation works. The Los Angeles Superior court system reports that 63% of cases ordered into mediation are resolved. Nationwide, the mediation success rate ranges between 60%-90%. [Final Report of Colorado Governor's Task Force on Civil Justice Reform, Exhibit 7]

Mediation does have its limits. In real estate matters, mediation is limited to resolving disputes involving buyers and sellers. Landlord-tenant disputes and trust deed defaults are largely based on very specific statutory requirements for performance which are either satisfied or unsatisfied, leaving little room for negotiation. Mediation is a tool best used by disputants in sales of property and agency disputes.

# Chapter 8 — Time to perform

*This chapter looks into the enforceability of one person's right to cancel a transaction when the other person fails to perform by an appointed date.*

***Chapter 8 Outline***

*Default and cancellation*
*Purpose of the time-essence provision*
*Termination of rights*
*Cancellation factors*
*Elements of a default*
*Time to close extended by notice*
*Intent in conflict with time-essence clause*
*Default needed to justify cancellation*
*To cancel you must first perform*
*When failure to fund is not a default*
*Cancellation right waived by conduct*

***Chapter 8 Terms***

| | |
|---|---|
| *Conditions concurrent* | *Notice of Cancellation* |
| *Conditions precedent* | *Right to cancel* |
| *Conditions subsequent* | *Risk of cancellation* |
| *Failure to deliver* | *Time-essence provision* |
| *Inconsistent conduct* | |

**Default and cancellation**

The short, seemingly harmless **time-is-of-the-essence provision** stands alone amongst the boilerplate provisions of some, but not all, stock purchase agreement forms used to buy and sell real estate in California. By its plain words, the existence of a time-essence provision **gives notice** to the buyer and seller that their compliance by the date scheduled for an event to occur or a condition to be met as called for in the purchase agreement or escrow instructions is **essential to the continuation** of the transaction.

Thus, the bargain built into the purchase agreement by the presence of the **time-essence provision** gives the buyer or seller the right to **immediately cancel** the transaction on the failure of an event to occur or the other person to approve a condition by the appointed date.

By virtue of the multiple number of tasks a typical buyer undertakes to close a transaction, contrasted with the very few tasks imposed on a seller to close, the time-essence clause "stacks the odds" of losing a transaction against the buyer. This condition exists even though the buyer and all the third parties involved on their behalf may have acted with diligence at all times.

Further, for a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places a **risk of cancellation** on a transaction which is not helpful. Foreseeable delays in closing a transaction exist in all real estate sales.

Worse yet, the time-essence clause has, over the years, consistently demonstrated an ability to **produce litigation** over rights to money or ownership which have been lost or forfeited by a cancellation that is typically initiated by the seller.

*Editor's note — **first tuesday** purchase agreement forms do not contain a time-essence clause. Instead, the purchase agreements authorize agents to extend performance dates by up to one month. [See **first tuesday** Form 150]*

**Purpose of the time-essence provision**

The "common understanding" said to exist as the purpose for including a time-essence clause in a purchase agreement is to **protect the seller from delays** in the buyer's payment of the sales price. Delays "tie up" both the seller's ownership of the real estate and receipt of the net sales proceeds beyond the date or period fixed for the transfer of ownership.

Another less logical theory for enforcing appointed dates as deadlines for the occurrence of events or the approval of the conditions called for in agreements containing a time-essence clause is the purported inability of courts to estimate the compensation owed a seller for losses resulting from a delay in the close of escrow due to the buyer's failure to perform.

However, delays in closing of a few days or even a few weeks or more, while inconvenient, rarely cause any compensable loss of money, property value, rights or property for the person attempting to cancel due to the passing of a performance deadline. Typically, the cancellation by a seller is motivated not by time, but by greater profits to be had elsewhere, i.e., "money is of the essence."

Even if a money loss is incurred due to a delay in performance, the loss is usually sustained by the seller and is easily calculable. Seller losses typically consist of lost rental value (or carrying costs of the property) for the period beyond the appointed closing date to the actual date of closing. An infrequent exception which occurs and causes the seller an incalculable (and uncollectible) loss arises out of the seller's actions in different transactions, such as the seller's reliance on the closing of a sale (not his entry into the sale) to complete some other transaction.

As for the buyer, his losses on a seller's default usually arise out of a missed closing deadline which he needed to meet in order to receive tax benefits or a locked-in (low) interest rate loan.

**Termination of rights**

An effective *Notice of Cancellation* interferes with the completion of a transaction as initially envisioned by the buyer and seller at the time they entered into the purchase agreement and escrow instructions.

On a proper cancellation, the person terminating the purchase agreement transaction **does not need to further perform** any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist. [See **first tuesday** Form 183]

For example, the person who **properly cancels** a purchase agreement has the unfettered right:

- in the case of a seller, **to retain ownership** or resell the property to other buyers at a higher price; and

- in the case of a buyer, *to keep his funds* or use them to purchase other property on a better bargain.

These rights to act, free of purchase agreement and escrow obligations, are the very objectives met by canceling the purchase and escrow agreements. The alternative to canceling both agreements is an attempt to keep the transaction together by determining the additional time reasonably needed by the other person to perform as originally contemplated, and then granting an extension of time in which to do so.

Should the "grace period" of additional time be granted, and then expire without compliance, a cancellation for failure to then perform is most understandable by all involved, and enforceable. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

Still, an effective **cancellation** by one person *forfeits the rights* held by the other to close the transaction and receive the benefits bargained for on entering into the purchase agreement. Further, on an effective cancellation, the agents, escrow, lender and title company are all adversely affected by the cancellation's ripple effects since they all lose the time and effort they invested to get the transaction closed.

For example, when a seller cancels, the buyer loses, by **forfeiture**, his contract right to become the owner of the property. Conversely, if the buyer cancels, the seller loses the right to receive funds and be relieved of the obligation of ownership.

Thus, a cancellation by either the buyer or the seller, if proper and enforceable, is the "final moment" in the life of a purchase agreement and escrow. Cancellation spells the end to all expectations held by everyone directly or indirectly affiliated with the sale who would have benefitted by the closing of the transaction.

*Editor's note — For simplicity's sake, the following discussion will mostly refer to the timing of a seller's cancellation. However, the discussion fully applies to a buyer's cancellation as well.*

## Cancellation factors

For a seller to successfully cancel an escrow based on the failure of an event to occur or a condition to be approved, the **purchase agreement** or escrow instructions should contain:

- a clear **description of the event** which is to occur or the condition to be approved;
- an appointed date or **expiration of a time** period by which the event or approval described is to occur; and
- a written provision stating in clear and unmistakable wording, understandable to the buyer, that the seller has the **right to cancel** the transaction as the consequence of a failure of the event or the approval to occur by the appointed date.

If provisions in the purchase agreement or escrow instructions meet all of the above criteria, then the seller will only be **allowed to cancel** if:

- the seller has performed all acts which must precede, by agreement or necessity, the event or approval triggering the cancellation (in other words, the seller cannot be in default);
- the event or approval **fails to occur** by the appointed date; and
- the seller **performs or stands ready,** willing and able to perform all other acts necessary on the part of the seller to close the transaction on the appointed date for the failed event or approval.

The notice given by the existence of the time-essence provision advises the buyer that his performance of the event which is to occur or be brought about by the date scheduled is **critical to the continuation** of the purchase agreement and escrow instructions. Thus, the time-essence provision sets the buyer's reasonable expectations of the consequences of his failure to perform, i.e., the risk that the seller may cancel the transaction and the buyer's right to buy the property will be forfeited.

However, the consequences of the failure of the buyer to perform or for an approval or event to occur depend upon the type of **time-related provision** contained in the purchase agreement and escrow instructions. The different provisions which might be included are:

**Figure 1**

*Excerpt from **first tuesday** Form — 150*
*Purchase Agreement — One-to-four Residential Units*

**10. ACCEPTANCE AND PERFORMANCE:**

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

- a **time-essence provision**, which gives the seller the **right to cancel** should the event or approval of a condition called for not occur by an appointed date;

- a *seller-may-cancel contingency* provision, which authorizes the seller to cancel should the condition or event not occur, whether or not a time-essence clause exists;

- an **authorization-to-extend** provision, which grants the agents the power to extend performance dates up to 30 days (or other wording indicating an accommodation for delays), whether or not a time-essence clause or a seller-may-cancel clause exists [See Figure 1]; and

- an **extension of time granted** by the seller, typically in supplemental escrow instructions, with wording imposing strict adherence to the new performance deadlines and authorizing the seller to cancel on expiration of the extension should the event or approval not be forthcoming.

**Elements of a default**

Before either a buyer or seller can effectively cancel a transaction, they must "place the other person in default." Thus, in order for a person to exercise the right to cancel, that person cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur.

For the buyer or seller to place the other in default, three transactional facts must exist:

- a date crucial to the continuation of the transaction must have passed;

- the condition called for in the purchase agreement did not occur by the scheduled date; and

- the person canceling must have fully performed all activities required of him in order for the other person to perform by the scheduled date, called *conditions precedent*, and have performed or be ready, willing and able to perform, at the time of cancellation, all activities he was obligated to perform in order to close escrow, called *conditions concurrent*.

**Was the cancellation timely**

The **setting of a time** for an act or event to occur does not, by itself, automatically allow a purchase agreement transaction to be terminated by one person when the appointed date has passed and the other person has not yet performed.

To permit a cancellation immediately following the expiration of the appointed time for performance, the purchase agreement or escrow instructions must clearly state it is the intention of both parties that the failure by one or the other person to perform by the appointed day will subject his contract rights to forfeiture.

Thus, clear cut wording throughout the purchase and escrow documents must consistently manifest an intent to **make time for performance crucial** to the continued existence of the transaction. If not so worded, the appointed date has insufficient significance to justify instant cancellation.

For example, sometimes the only wording regarding any right to cancel a transaction appears in the escrow instructions. Escrows are nearly always instructed to close at any time after the date scheduled for closing if escrow is in a position to do so, provided escrow has not yet received instructions to cancel escrow and return documents and funds.

Thus, in this example, neither the purchase agreement nor the escrow instructions contain a clause stating "time is of the essence in this agreement." Further, no clear, unequivocal or unmistakable wording in any contingency provision shows an intent on the part of the buyer and seller to make time of the essence, such as wording giving the seller or buyer the "right to cancel" on the failure of either the other person to perform a described activity or for an event to occur by a scheduled date.

Under these examples, which lack time-essence provisions, the time appointed for the delivery of such items as loan commitments, termite reports, funds for closing or clearance of encumbrances from title is merely a "target date" preliminary to establishing the right to cancel.

**Time to close extended by notice**

To establish the **right to cancel** when time is not stated or established in the purchase agreement or escrow instructions as crucial, the person in default must be *given notice* that the date set as the "new deadline" will be strictly adhered to.

Further, the person in default must be given a realistic opportunity (period of time) after being given a notice to perform before any cancellation would be effective. Continued nonperformance past the new deadline date will be treated as a **default** and escrow can be immediately canceled. [See Form 181-1 accompanying this chapter]

For example, a purchase agreement calls for a buyer to close escrow within 45 days after acceptance. No time-essence clause, cancellation provisions (other than the *implied right* to cancel exercisable on a failure of the other person to perform) or agent authorization to extend performance dates exists. [See **first tuesday** Form 150]

The seller agrees with the buyer's request to extend the date of performance (closing) an additional 30 days during which the buyer is to complete his arrangements to close escrow. Two days after the extension expires, the seller cancels the transaction.

Is the seller's cancellation of the transaction effective?

Yes! The 30-day extension was a **reasonable amount of time** for the buyer to perform before the seller **exercised** his right to cancel. A further unilateral extension of time is not needed for the cancellation to be reasonable and effective. [Fowler, *supra*]

## NOTICE TO PERFORM AND INTENT TO CANCEL

**Prepared by: Agent** ____________________________ | **Phone** ______________________
**Broker** ____________________________ | **Email** ______________________

**NOTE:** This form is used by a party to a transaction who has performed to advise another party who has not performed as agreed to perform by a specified date or expect the transaction to be cancelled.

**DATE:** _____________, 20______, at ____________________________________________________, California.

**1.** This notice regards the performance of a Purchase Agreement

1.1 entered into between ____________________________________________________, as the Seller, and
________________________________________________________________________, as the Buyer,

1.2 dated __________, 20______, at ________________________________________________, California,

1.3 regarding real estate referred to as ______________________________________________, and

1.4 escrowed with ________________________________________________________________,
escrow number _____________________________, under instructions dated _____________, 20______.

**NOTICE TO PERFORM:**

**2.** Demand is hereby made on you under the above referenced agreement and escrow instructions to perform

2.1 on or before _____________, 20______,

2.2 as follows: ____________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________

**3.** It is the intent of the undersigned to cancel this transaction should the performance demanded of you in this notice not occur during the time period given.

**I agree to this notice.**

Date: _________________, 20_______

By: ______________________________________________________

Signature: _________________________________________________

By: ______________________________________________________

Signature: _________________________________________________

Now, consider an example of strict compliance with performance dates as "deadlines," after which the purchase agreement and escrow can be terminated by cancellation for failure of the described activity or event to take place. The **purchase agreement** contains a simple time-essence clause. Authority is not granted to the agents to extend performance dates should the appointed date for performance prove to be an inadequate amount of time for either the buyer or seller to complete or bring about all of their closing activities.

Consistent with the time-essence clause in the purchase agreement, **escrow instructions** provide for an interference with closing of the escrow after the date initially targeted for closing. The instructions authorized escrow to close at anytime after expiration of the escrow period, unless escrow received instructions calling for the return of documents and funds.

One day after the passing of the date scheduled for closing, the buyer cancels escrow. Twelve days later, the seller, using diligence at all times, is able to clear title and close. The seller challenges the buyer's cancellation as premature and ineffective, claiming the buyer is required to grant him the additional time needed to close escrow before the buyer can *forfeit the seller's right* to enforce the buyer's promise to purchase the property.

Is the seller entitled to the additional time he needs to close escrow?

No! The seller was **on notice** by the existence of the time-essence clause in the purchase agreement and the wording of the escrow instructions that the buyer had the right to cancel on failure of escrow to close by the date scheduled. No provision in any document expressed an intent which was contrary to the time-essence provision in the purchase agreement.

Thus, the buyer's cancellation, one day after the appointed closing date, was in accordance with the **intent stated** in the purchase agreement and escrow instructions, i.e., that timely performance was essential to the continuation of the agreement.

More importantly, **escrow was authorized** to return the money and instruments on the demand of either the buyer or seller should the closing not occur on or before the date set for closing. Thus, the buyer was not required to grant the additional time reasonably necessary for the seller to close the transaction. [**Ward** v. **Downey** (1950) 95 CA2d 680]

**Intent in conflict with time-essence clause**

Consider a sale under a purchase agreement (or escrow instructions) which contains a provision **authorizing the agents to extend** the time for performance of any act for a "period not to exceed one month." The purchase agreement also includes a boilerplate provision that "time is the essence of this agreement."

Escrow is for a 60-day period, the end of which is the appointed date for closing the transaction. As usual, the escrow instructions state escrow may close at any time after the date scheduled for closing, unless instructions to the contrary have been received.

On the date scheduled for closing, escrow is not in a position to close due to the buyer's inability to immediately record his purchase-assist loan. The seller immediately cancels escrow in an attempt to terminate the transaction, claiming time was of the essence by agreement.

Can the seller cancel without giving an extension of time when both a time-essence and an authority-to-extend provision exist?

No! The bargain struck by the conflicting provisions controlling performance dates did not contemplate time for the occurrence of activities or events by their appointed dates to be so essential that the transaction could be canceled on the mere passing of the appointed date. The use of a purchase agreement (or escrow instructions) containing wording that "time is of the essence" does not allow for the forfeiture of contract rights on a failure to perform within the agreed time period when **other provisions express a contrary intent**.

When logically possible, courts ignore boilerplate time-essence clauses and enforce the original bargain, if no financial harm results from the delay.

Here, the purchase agreement (or escrow instructions) gave the agents the unconditional right to extend performance dates. Thus, being able to close by the date set for closing escrow could hardly be considered crucial to the continued viability of the transaction. Accordingly, the seller must give the buyer a **reasonable amount of time** to close escrow, i.e., the additional days needed for the agent to record the buyer's loan, before the buyer's failure to perform justified exercising any cancellation rights. [See Form 181-1]

*Editor's note — The fact the agents do not exercise the authority granted them to extend the time for performance is of no concern. It is the mere existence of the agents' unrestricted right to extend performance dates by up to 30 days which requires the person canceling to allow the other person a reasonable, additional time period in which to perform before cancellation can occur.*

### Default needed to justify cancellation

Before a buyer or seller may consider canceling a transaction, the other person must have *defaulted* on his completion of an activity or an event has failed to occur.

For example, a seller cancels a 30-day escrow the day after the date it is scheduled to close. The purchase agreement granted the agents authorization to extend performance dates, including the date for closing, up to 30 days. [See Figure 1]

Thirty-three days later, for a total of 63 days from the date of acceptance, the buyer, using diligence in the pursuit of a loan, obtains final loan approval and has all the funds needed to close escrow.

Is the seller's cancellation effective without first giving an extension of additional time for closing when the buyer has not performed by the date scheduled for the close of escrow?

No! The buyer is not yet in default. Sixty-three days is a reasonable period of time for the buyer to obtain the purchase-assist mortgage funds agreed to in the purchase agreement. Most importantly for the buyer and agents, time for closing was not made crucial to the continuation of the agreement.

Thus, a reasonable period of time must pass before the buyer is in default. Only when the buyer is in default may the seller *exercise* his right to cancel. [**Henry** v. **Sharma** (1984) 154 CA3d 665]

Now, consider an agent who prepares a purchase agreement and inadvertently fails to set a fixed time period for the opening of escrow. However, the purchase agreement does state an appointed date for closing escrow as 60 days from the date the purchase agreement was entered into.

The buyer fails to sign and return escrow instructions to open escrow.

The seller cancels the transaction 12 days after the date escrow was scheduled to close.

Was the buyer in default at the time of cancellation?

Yes! The buyer was in default for his failure to sign and return escrow instructions. The buyer had an obligation to open escrow within an unstated period of time. Since the time for opening escrow was not agreed to, a **reasonable period of time** for opening escrow is allowed.

A reasonable period for opening escrow is a date sufficiently in advance of the date set for the close of escrow to give escrow enough time to perform its tasks by the date scheduled for closing. The cancellation 12 days after the closing date was effective to terminate the transaction. A reasonable period for the buyer to open escrow ended well before the scheduled closing date.

The buyer, having failed to open escrow before the closing date, was in default on the closing date. Thus, the buyer lost his right to buy the property since he did not cure the default by opening escrow before the date set for closing and the seller's cancellation. [**Consolidated World Investments, Inc.** v. **Lido Preferred Ltd.** (1992) 9 CA4th 373]

However, a one day delay by a buyer before signing and delivering instructions to open escrow does not allow a (remorseful) seller to cancel the transaction and avoid closing escrow. Reasonably, a **one day delay in opening escrow** is not a default at all, even when time is unequivocally declared to be of the essence in the purchase agreement.

**To cancel you must first perform**

Consider a seller who wants to cancel a transaction since the **buyer is in default** under the purchase agreement or escrow instructions. Before the seller may cancel, **the seller must**:

- **perform all acts** and cause all events to occur which, by agreement or necessity, are the seller's obligation and must occur before the buyer becomes obligated to perform or can perform, called **conditions precedent**, such as delivering disclosures, reports, etc., or completing repairs requiring the buyer's approval;

- **fully perform all activities** and obligations imposed on the seller which are to **occur at the same time** as the buyer's performance, without concern for whether the buyer has performed, called **conditions concurrent**, such as handing escrow a grant deed and all other information and items required of the seller for escrow to clear title and close; and

- **perform or demonstrate** he can perform all other activities or bring about events which are the obligation of the seller for closing the transaction, whether or not the buyer ever performs, called *conditions subsequent*, such as meeting any requirements of the buyer's lender for repairs or clearances.

Thus, while the buyer may have failed to perform by the time agreed, the seller may not cancel until the seller has performed or stands ready, willing and able to perform under the above three conditions (precedent, concurrent and subsequent), conditions which exist in most purchase agreements and escrow instructions.

**When failure to fund is not a default**

On the date set for the close of escrow, buyers often have not deposited their down payment funds into escrow as called for in the purchase agreement and escrow instructions. When the deposit of closing funds or the lender's wire of loan funds does not occur as scheduled, the buyer clearly has not yet performed his obligation to close escrow. However, the failure to fund does not necessarily mean the buyer is in default.

The question which arises for a seller who is attempting to cancel when time has been established as essential and the buyer or the buyer's lender has not delivered closing funds, is whether the buyer is either in **default** or is **not yet obligated** to deposit funds.

Escrow, as a matter of custom, will not call for a wire of closing funds from the mortgage lender or the buyer until **escrow is in a position to close**. Escrows, as an entirely practical matter, do not want closing funds sitting in an escrow which is not yet ready to close.

Specifically, before escrow calls for closing funds, the seller must have already fully performed by providing documents (deeds, releases, reconveyances, title clearances, etc.) so the conveyance of title can be insured and property clearances, prorates and adjustments can be delivered and accounted for as called for in the escrow instructions. If the seller has not delivered instruments so escrow can be in a position to close by the date scheduled for closing, escrow will not make a demand on the buyer (or lender) for funds. The deposit of closing funds would be premature since escrow cannot yet close.

Further, when the closing is contingent on the buyer recording a purchase-assist loan, escrow, as a matter of *commercial necessity*, does not call for the buyer's funds until the lender is ready to fund.

**Figure 2**

*Excerpt from **first tuesday** Form — 150*
*Purchase Agreement — One-to-four Residential Units*

12.2 Escrow to be handed all instruments needed to close escrow on or before ____________, 20______, or within ______ days after acceptance. Parties to hand Escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **ft** Forms 310 and 311]

Thus, the buyer has no obligation to deposit any money into escrow and is not in default until escrow has received the lender's documents and requests the buyer's funds, which the buyer **then fails to deliver**. Until the buyer is in default due to a failure to timely respond to escrow's request for funds, any attempt by the seller to cancel is premature and ineffective.

Escrow instructions usually state the buyer is to deposit funds for use by escrow **provided the seller has performed**. Thus, the obligation of the buyer to deposit closing funds is subject to the seller first performing, called a **condition precedent** to the buyer's performance. Therefore, the buyer's "failure" to deposit funds before escrow is in a position to close is **excused**. The seller has failed to hand escrow documents and information sufficiently in advance of the scheduled closing date for escrow to close by the appointed date. [See Figure 2]

Consider a seller who is unable to convey title to a buyer and deliver a title insurance policy by the closing date called for in the purchase agreement and escrow instructions. The title company cannot issue a policy as ordered due to encumbrances affecting title, such as abstracts, trust deeds, leases, tax liens, assessments, etc., which have not been released and the amounts needed for discharge and payoff have not yet been determined.

Here, the time for closing has arrived and the seller cannot deliver a marketable title as agreed. Thus, until the seller obtains title insurance for his deed, the buyer is not in default for not yet depositing his funds.

### Cancellation right waived by conduct

Even when the date scheduled for a buyer or seller to perform is established as crucial, thus allowing one person to immediately cancel on the other's default, *inconsistent conduct* by the person entitled to cancel constitutes a *waiver* of his right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is **no longer in default**. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

For example, the date set for escrow to close arrives. The seller has not yet handed escrow (or the buyer) clearances which are required before escrow may close.

A few days after escrow is scheduled to close, the seller deposits the clearances with escrow. The buyer then deposits his closing funds on a call from escrow.

Two days later, the seller cancels escrow, claiming the buyer was in default since he failed to deposit his funds by the appointed date.

Here, the cancellation is ineffective and the buyer is entitled to close escrow. The seller **waived his right** to cancel, time having been of the essence, by conducting himself without concern for the passing of the appointed date for closing. The seller failed to deliver up documents or information sufficiently in advance for escrow to meet the deadline. [**Katemis** v. **Westerlind** (1953) 120 CA2d 537]

However, a **waiver by inaction** does not occur simply because a person's right to cancel the transaction is not immediately exercised on the failure of the other person to perform or an event to occur. **Affirmative conduct must occur** by the person entitled to cancel, not just mere inaction, before the right to cancel under a time-essence situation is waived.

After a waiver of a date scheduled for approval of a condition or occurrence of an event, time must be **reinstated as crucial** to the continuance of the transaction, or a reasonable, additional period of time must have passed after waiver of the right to cancel, before the transaction can be canceled.

**Time is best reinstated** as essential to the continuation of the transaction by notifying the person who needs to perform that he must perform by the end of an additional period of time, set with sufficient duration as is needed to provide him with a realistic opportunity to perform.

If performance is not forthcoming during the additional period of time, the transaction may be promptly canceled since *strict compliance* with the extension is now enforceable.

# Buyer and Seller Alternatives

# Chapter 9 — Real estate purchase options

*This chapter demonstrates the use and effect of option-to-buy agreements in real estate sales.*

### *Chapter 9 Outline*



### *Chapter 9 Terms*

| | |
|---|---|
| *Actual or constructive notice* | *Optionee* |
| *Contingency provisions* | *Optionor* |
| *Due diligence* | *Option to buy* |
| *Exercising the option* | *Option period* |
| *Investment memorandum* | *Syndication* |

**An irrevocable offer to sell**

A real estate syndicator searching for investment-grade, income-producing real estate locates a property which appears to be financially suitable for a group investment, a real estate brokerage activity called *syndication*.

However, the syndicator will not commit himself to the purchase of the property until he has **fully investigated** the condition of the improvements, the property's operations and the availability of mortgage financing, an effort called *due diligence*.

Further, on completing his **due diligence** investigation, and if conditions are found to be acceptable, the syndicator will need additional time to prepare an *investment memorandum* and to **locate investors**. The memo will contain his narrative report on the significant information he has gathered concerning the worth of the property. The report will be circulated among equity investors as a solicitation to form a group to fund the acquisition of the property for long-term ownership.

First, before the syndicator begins his in-depth analysis of the property, he needs to enter into an enforceable purchase agreement with the seller. Without an agreement to acquire the property, the property may be sold to someone else before he can complete his investigation and determine the property is suitable for acquisition. For the same reasons, the syndicator chooses not to engage in the use of a letter of intent. [See **first tuesday** Form 185]

To acquire the right to buy the property without unconditionally committing himself to purchase the property, the syndicator submits an offer which calls for the occurrence of several events before he becomes committed to the purchase of the property in provisions called *contingency provisions*.

The **contingency provisions** include approval of the property's physical condition, its leasing income and operating expenses, available mortgage financing, title and zoning restrictions on use, and the existence of equity investors to fund the closing.

The seller fully understands the contingencies are designed primarily to enable the syndicator to confirm his understanding of the property's condition as represented by the seller and to obtain the mortgage and equity financing needed to fund the close of escrow. However, the seller is concerned the syndicator's inability to satisfy and remove the contingencies could interfere with the seller's ability to promptly cancel the agreement should the syndicator fail to close or cancel the transaction by the date scheduled for closing.

The seller decides not to accept the syndicator's purchase offer due to uncertainty regarding the syndicator's timely performance.

**The option to buy as a counteroffer**

However, the seller is willing to grant the syndicator an *option to buy* the property at the same price and for the same time period sought by the syndicator in his offer to purchase. Thus, the seller counters the offer.

Here, a counteroffer form will not be used to respond to the syndicator's offer. A counteroffer would incorporate the terms of the syndicator's purchase offer, subject to any modifications stated in the counteroffer.

In this situation, the seller simply prepares and hands the syndicator an **offer to grant an option**. Thus, the seller **rejects** the syndicator's offer in its entirety. [See Form 160 accompanying this chapter]

The seller's offer to grant an option requires the syndicator to accept the offer and the terms of the proposed option agreement before the seller is bound to deliver the signed option agreement. To accept the seller's offer to grant an option, the syndicator must sign the acceptance provision in the offer and return it to the seller. Of course, the acceptance must occur before expiration of the seller's offer to grant the option.

For the syndicator, his purchase of an **option to buy** property imposes no obligation on him to open escrow and purchase the property. Unlike a real estate purchase agreement, the buyer holding an option to buy has **no obligation to purchase** the property.

## OFFER TO GRANT AN OPTION

And Option Money Receipt

**Prepared by: Agent** ____________________ | **Phone** ____________________
**Broker** ____________________ | **Email** ____________________

**NOTE:** Recommended for use with **first tuesday** Form 161 or 161-1.

**DATE:** __________, 20_____, at ________________________________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** On acceptance of this offer, ________________________________________, as the Optionor,
1.1 to grant, ________________________________________, as the Optionee,
1.2 an option to purchase property on terms and conditions set forth in the attached option agreement,
1.3 regarding property situated in the City of _______________, County of _____________, California,
1.4 referred to as ________________________________________.

**TERMS:**

**2.** This offer is conditioned on the tender of option money by Optionee in the sum of $____________, evidenced by: ☐ cash, ☐ cashier's check, ☐ personal check, ☐ ________________________, payable to Optionor to be held by Broker, undeposited, until delivery to Optionee of the option agreement signed by Optionor.

**3.** ☐ Parties to sign attached carryback disclosure statement which is a part of this agreement. (Mandatory if under the terms of the option, Optionor is to carry back paper on four-or-less residential units.) [See **ft** Form 300]

3.1 ☐ Optionee to hand Optionor a completed credit application on acceptance. [See **ft** Form 183] Optionor may terminate this agreement within _____ days of acceptance by delivering to Optionee, Optionee's Broker or Escrow, a written Notice of Cancellation based on disapproval of Optionee's credit. [See **ft** Form 183]

**4.** Seller's *Natural Hazard Disclosure Statement* [See **ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review, in which case Buyer may terminate the agreement within ten days of receipt based on a reasonable disapproval of hazards disclosed by the statement and unknown to Buyer prior to acceptance of this offer. [See **ft** Form 183]

**5.** On acceptance of this offer, the below mentioned Broker(s) are to be paid a fee of ____________ by ☐ Optionor, or ☐ Optionee. Optionor's Broker and Optionee's Broker, respectively, shall share the fee on the following ratio ________:________.

**6.** This offer for option shall be deemed revoked unless accepted in writing by signing this offer and its attachment(s) and delivering same to the party making this offer or their broker on or before ___________, 20_____.

**OPTIONOR'S BROKER:** ____________________
Broker's DRE Identification #: ____________________
Agent's Name: ____________________
Agent's DRE Identification #: ____________________

Signature: ____________________
Is the agent of: ☐ Optionor exclusively.
☐ Both Optionor and Optionee.
Address: ____________________
____________________
Phone: ______________ Cell: ______________
Email: ____________________

**OPTIONEE'S BROKER:** ____________________
Broker's DRE Identification #: ____________________
Agent's Name: ____________________
Agent's DRE Identification #: ____________________

Signature: ____________________
Is the agent of: ☐ Optionee exclusively.
☐ Both Optionor and Optionee.
Address: ____________________
____________________
Phone: ______________ Cell: ______________
Email: ____________________

**OPTIONOR:**
**I agree to grant this option on the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: ___________ 20_____
Signature: ____________________
Signature: ____________________

**OPTIONEE:**
**I accept this option on the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: ___________, 20_____
Signature: ____________________
Signature: ____________________

**FORM 160** 03-11 

Conversely, the option contains the seller's irrevocable offer which **obligates the seller to sell** the property on the terms stated in the option agreement should the syndicator decide to buy the property within a set period of time, called the *option period*. The syndicator only agrees to buy the property when he **timely accepts** the seller's irrevocable offer to sell, an acceptance called *exercising the option*.

In exchange for the seller granting an option on the property, the syndicator will pay the seller *option money*. The amount of option money is the price the syndicator pays to **buy the option** and "tie up" the property by removing it from the market. [See Figure 1]

Thus, the option agreement allows the syndicator to control the property without committing himself to purchase it until he exercises the option, if ever. His completion of the property analysis and solicitation of investors will indicate whether he will exercise the option or not.

However, when the syndicator exercises the option, a **bilateral sales contract** is automatically formed, no differently than had he accepted an offer from the seller to sell the property under a purchase agreement containing nearly identical terms. Thus, on exercise, both parties become obligated to perform as agreed and must proceed with closing the sale since no contingencies exist. [**Caras** v. **Parker** (1957) 149 CA2d 621]

Should the syndicator let the **option period** expire without **exercising the option**, the seller will be able to sell the property to another buyer, unaffected by the option since the seller's irrevocable offer to sell represented by the option has expired.

In an option agreement, the owner is referred to as the *optionor* and the potential buyer is referred to as the *optionee*. They become the seller and buyer, respectively, on exercise of the option.

*Editor's note — An option granted to a buyer is to be distinguished from an exclusive right-to-sell listing granted to a broker. On entering into a listing, the seller incurs no obligation to sell the property to anyone. The owner has only employed the broker as his agent to find a buyer and represent the seller in negotiations. The broker has not received the power-of-attorney authority needed to commit the seller to a sale of the property and the listing is not an offer to sell anything.*

## Granting an option

Consider a broker who is employed by a seller under a listing agreement which states the broker will receive a fee if he negotiates a sale, exchange or the grant of an **option to purchase** the seller's property. [See **first tuesday** Form 102 §10]

An agent of the broker locates a qualified buyer. The seller grants the buyer, also called an **optionee**, an option on the receipt of *option money* paid by the buyer. The broker receives no fee on the grant of the option, although he is entitled to a fee under the listing. Also, the option does not contain a fee provision.

After the listing expires, the buyer exercises the option and acquires the property.

The broker makes a demand on the seller for a fee under the listing agreement. The seller refuses, claiming the broker is not entitled to a fee since the buyer exercised the option after the listing agreement expired and the option did not provide for a fee on its exercise.

Here, the broker did earn a fee. During the listing period, the seller granted the buyer an option to buy the property, which the buyer later exercised to acquire the property. [**Anthony** v. **Enzler** (1976) 61 CA3d 872]

Thus, when an option is exercised, the sale relates back to the **time the option was granted**, i.e., during the listing period. This **relation back** is roughly comparable to entering into a purchase agreement or opening an escrow during the listing period, and closing the transaction after the listing expires.

Alternatively, consider a seller who agrees to pay a broker a partial fee on the granting of an option without any reference to payment of a further fee on the exercise of the option. To avoid the lost expectations of the payment of a further fee on exercise, the broker or his agent must then include a fee provision in the body of the option. [See Form 160 §6]

**Benefits for opposing positions**

An option agreement provides benefits for both buyer and seller.

A **buyer** should consider acquiring an option when:

- he does not yet want to commit himself to buy;
- he is speculating in a depressed market that values will soon rise;
- he needs time to investigate and determine whether the property will operate profitably;
- he needs time to do promotional work such as syndicating, subdividing, rezoning, obtaining permits or loan commitments, or to complete a §1031 reinvestment; or
- he is a tenant and may want to own the leased premises some day.

A **seller** should consider granting an option when:

- he wants to retain ownership rights to the property for a fixed period into the future (for tax purposes);
- he wants to sell at a price based on higher future market values;
- he needs to provide an incentive to induce a prospective tenant to lease the property; or
- he wants to give a promoter incentive to work up a marketing or use plan and buy the property.

## Multiple option periods

Developers require a longer initial option period, or the right to extend the option period, to provide time in which to study a property, obtain government clearances and locate financing for development. If these objectives are met, the developer will be able to purchase the property on a previously agreed set of terms.

Thus, it is foreseeable a developer may need **additional time** beyond the initial option period to complete his due diligence and approval process before committing himself to the purchase of the "optioned" property. Here, the option agreement should include the right to buy one or more extensions of the option period on the payment of additional option money before the expiration of the preceding option period. [See **first tuesday** Form 161-1]

The developer who determines he will be unable to develop or to successfully market a development of the property will simply not exercise the option.

## Lease with option

The other significant use of an option to buy relates to residential and nonresidential leasing arrangements. Prospective tenants might want the ability to later acquire ownership of the property they will be occupying.

Tenants often need to invest substantial dollar amounts in tenant improvements to tailor the property to the tenant's needs. Whether contracted for by the tenant or the landlord, the tenant pays for the improvements either by a lump sum, upfront expenditure or by payments amortized over the initial life of the lease as part of the monthly rent.

Also, installation of racks, cabinets, shelving, trade fixtures, lighting and other interior improvements will be needed to make the premises fully compatible for the tenant's occupancy. These too will be paid for by the tenant. Always, a degree of "goodwill" is built up with customers due to the location of the business on the property. Thus, the location becomes part of the value of the tenant's business so long as he remains at the location.

All these opportunities will be lost if the landlord refuses to extend the lease or his demands for increased rent under an option to extend the lease compels the tenant to relocate. A tenant with even a small degree of insight into his future operations at the location will attempt to negotiate some sort of option to purchase the property. At least an option to renew at lesser rental rates should be negotiated, as the tenant improvements (TIs) have been paid for by the tenant and the landlord has fully recovered any costs he may have incurred.

A lease with an option to purchase must be distinguished from the purchase rights held by a tenant under a right of first refusal agreement or a buyer under a lease-option sales arrangement. [See **first tuesday** Form 163; see Form 579 accompanying Chapter 10]

## Option money as the consideration needed

An option agreement is not enforceable unless a seller receives some sort of consideration. Unless the seller is given something in exchange for the right he has **surrendered** to revoke his offer to sell or to sell the property to others, the option fails for **lack of consideration**. Without the payment of consideration, the agreement is merely an offer to sell which may be **withdrawn at any time** by the seller. [**Kowal** v. **Day** (1971) 20 CA3d 720]

While consideration is needed to create an option agreement which is binding on the seller, the **amount of the consideration** paid for an option may be a minimal amount. An enforceable option can be created for as little as 25 cents paid by a buyer.

Also, the consideration given for the option does not need to be in cash. For instance, when an option to purchase is granted to a tenant who enters into a lease, the consideration given for the grant of the option rights is the tenant's signature obligating the tenant to perform on the lease.

In the case of a syndicator or developer using an option to control property he is not yet certain he wants to purchase, the consideration is the option money paid to the seller to grant the irrevocable offer to sell. The option money is typically set at an amount which will compensate the seller for the time the property is kept off the market, similar to a payment of rent or interest (less any actual and implicit income produced for the owner by the property).

Often a small amount of option money is paid for a short initial option period, sometimes called a "free-look" period. The term of the free-look option may be twenty to thirty days, granted on the payment of a small amount of option money, such as $100.

If the buyer is given extensions to continue the option after the free-look period, he usually is required to put up a more substantial amount of option money.

Any number of additional option periods may be agreed to, one following the expiration of another. The number of extensions depends only on the seller's willingness to grant the extensions and the buyer's willingness to put up more option money to pay for those extensions. [See **first tuesday** Form 161-1]

## Sufficiency of terms for enforcement

While consideration is necessary for a purchase option to be enforceable, a method for payment of the **purchase price** or a **closing date** are not.

Consider an owner and a tenant who sign a lease agreement granting the tenant an option to purchase the leased property.

The option includes the identities of both parties, a description of the property, and the price to be paid, but is silent on the escrow period for delivery of the price and deed after exercise of the option.

The tenant timely exercises the option and escrow is opened.

The owner responds by placing conditions on the escrow period not included in the option, negotiating to prolong the close of escrow until he locates a §1031 exchange replacement property.

The tenant counters, attempting to resolve the owner's demand for an **extended escrow** and his need to record a purchase-assist loan to fund the purchase price.

The owner then refuses to perform, claiming the option cannot be enforced since ongoing negotiations to resolve the time for payment of the price and delivery of the deed are essential terms and did not exist in the option.

Does the lack of terms regarding time for payment of the price and the delivery of the deed make the purchase option unenforceable?

No! An option agreement need only identify the parties involved, the property in question, and the price to be paid. When the option does not state the method for payment of the price or the length of the escrow period, the method for payment of the price is *implied* to be cash through escrow, and the time for payment of the price in exchange for the deed is **implied** to be of a **reasonable time period** (60 days) after exercise of the option. [**Patel** v. **Liebermensch** (2008) 45 C4th 344]

**Exercising the option**

Unless a particular **manner for exercising** the option is specified in the option agreement, any communication from a buyer to a seller of his intention to exercise the option is sufficient. [**Riverside Fence Co.** v. **Novak** (1969) 273 CA2d 656]

However, if the option agreement requires the buyer to take specific steps to exercise the option, the buyer must follow the **conditions set** in order to exercise the option and acquire the property. [**Palo Alto Town & Country Village, Inc.** v. **BBTC Company** (1974) 11 C3d 494]

For instance, an option agreement should require a buyer to sign escrow instructions and deposit cash in escrow to exercise the option. If the instructions are not signed, or if signed and the deposit is not made, the option has not been exercised. Thus, the buyer has not exercised his right to acquire the property.

**Proposed escrow instructions** should be prepared and attached as an addendum to the option agreement to avoid any conflict over the content of the instructions required to be entered into to exercise the option. The instructions will remain unnumbered, undated and unsigned until exercise of the option. [See **first tuesday** Form 401]

The escrow opened to exercise an option should call for escrow to close within a short period of time, i.e., the number of days required to prepare documents, order title reports and close. Unless an option agreement requires the buyer to sign escrow instructions, deposit funds and close escrow within a short period of time, the buyer's exercise of the option merely creates an enforceable bilateral purchase agreement with no escrow, funds or clear closing date.

**Recording the option**

When a purchase option or **memorandum** of the option is recorded, it becomes part of the property's chain of title, imparting *constructive notice* of the outstanding option rights to anyone later obtaining an interest in the property. A buyer, lender or tenant acquiring an interest in the property with *actual or constructive notice* of the existence of an option to purchase the property takes his interest in the property **subject to** the buyer's option rights.

Conversely, a buyer, lender or tenant who does not have actual knowledge of an unrecorded and unexpired option, takes his interest in the property free of the option.

For example, a seller grants a buyer an option to purchase property. Before the option is recorded or the buyer takes possession, the seller conveys the property to a second buyer. The second buyer did not have actual knowledge of the first buyer's option on the property.

The buyer who was granted the option later exercises the option by depositing the full amount of the purchase price into an escrow he has opened as agreed in the option agreement.

However, the seller who granted the option is no longer the owner of the property. Thus, he has no interest in the property to convey. Also, the option agreement is not enforceable against the second buyer since the second buyer, who is now the owner of the property, had no knowledge of the first buyer's option when he acquired ownership.

Thus, the conveyance of the property to the second buyer without notice of the unexpired option wiped out the first buyer's right to buy the property under the option. [**Utley** v. **Smith** (1955) 134 CA2d 448]

A recorded option **ceases to constitute constructive notice** of a buyer's option rights when:

- six months have run after the expiration date stated in the recorded option agreement or memorandum without the prior recording of an *exercise* or *extension* of the option; or

- six months have run after the option or memorandum was recorded should the expiration date not be stated in the recorded option agreement or memorandum. [Calif. Civil Code §884.010]

The purpose for the extinguishment of the recorded option from title is to protect buyers and sellers of property from old, unexercised and expired option rights which are of record. No such statutory scheme exists for the "outlawing" of unrecorded options which have expired.

# Chapter 10 Options to buy and the right of first refusal

*This chapter distinguishes the tenant's exercisable right to buy under the owner's irrevocable offer to sell from the tenant's preemptive right to buy should the owner later decide to sell.*

***Chapter 10 Outline***

*Purchase rights held by tenants*
*Option to buy vs. right of first refusal*
*The owner's motives*
*Consideration for granting an option*
*The option agreement*
*Right of first refusal*
*Matching the back-up offer*
*Reinstatement of the right of first refusal*

***Chapter 10 Terms***

| | |
|---|---|
| *Call option* | *Option period* |
| *Enforceable option* | *Option to purchase* |
| *Irrevocable right to purchase* | *Option to renew* |
| *Lis pendens* | *Pre-emptive right to purchase* |
| *Mutuality of obligation* | *Right of first refusal* |

**Purchase rights held by tenants**

A prospective tenant is negotiating to lease a single-user property. An offer to lease or letter of intent (LOI) is prepared by the tenant's leasing agent calling for the owner to grant the tenant an *option to purchase* the property, an irrevocable right to later buy the property at the **tenant's discretion**. If the owner agrees to grant an **option to buy**, he will be obligated to sell the property on the terms of the option if the tenant decides to buy.

However, the owner rejects the offer to lease because he is not willing to sell the property.

While negotiating a counteroffer with the landlord, the leasing agent discovers the owner is willing to grant the tenant a r*ight of first refusal* for the term of the lease, called a preemptive right. Thus, if the owner decides to sell the leased premises before the lease expires, the tenant could exercise the right to buy the property.

To exercise the **right of first refusal**, the tenant must accept the terms of sale the owner presents or match an offer made by another buyer.

Should the tenant decide not to exercise his right of first refusal, the lease remains in effect and he retains possession. If the property is sold to another person, however, ownership is transferred subject to the tenant's leasehold interest. On the owner's completion of the sale, the lease agreement will no longer include the preemptive right to acquire the property since the right of first refusal expired unexercised. [**Manasse** v. **Ford** (1922) 58 CA 312]

### Option to buy vs. right of first refusal

An owner and tenant may agree to a tenant's option to buy the property under provisions that grant the tenant either:

- an *irrevocable right to purchase* the property within a specific time period, called an option to buy; or
- a *pre-emptive right to purchase* the property if the owner later decides to sell the property, called a right of first refusal.

The option to buy is typically evidenced by an agreement separate from the lease agreement, since the option includes the terms of purchase which are unrelated to the lease. The option to buy is usually referenced in the lease and attached as an addendum. [See Figure 1]

Conversely, the right of first refusal is a provision included in the body of the lease agreement, or by an addendum, since the provision rarely contains the terms of a sale. [See Form 579 accompanying this chapter]

Unlike the right of first refusal, an **option to buy** must contain all terms needed to form an enforceable agreement to sell the real estate. The tenant holding an option to buy has the discretionary right to buy or not to buy on the sales terms stated in the option, and to do so within an agreed-to time period. No variations are allowed.

To buy the property under an option, the tenant **exercises** his right to buy through acceptance of the **irrevocable offer** to sell granted by the option. Thus, the decision to buy or not to buy the property rests at all times with the tenant, the owner having already agreed to sell.

Conversely, when an owner grants his tenant a **right of first refusal**, the tenant only acquires the right to buy or not to buy the property if the owner later decides to sell. However, once the tenant is notified of the owner's intent to sell, the right of first refusal becomes an option to buy on the terms offered by the landlord.

When the owner presents his offer to sell, the tenant has the right to accept the offer and buy the property within the fixed period of time for exercise by the right of first refusal provision. [See Form 579 §3.1]

### The owner's motives

An owner who desires to sell his property often uses the option to buy or a right of first refusal to induce a tenant to buy the property, rather than rent it.

## RIGHT OF FIRST REFUSAL TO BUY

Addendum

**Prepared by: Agent** ____________________________ **Phone** ______________________
**Broker** ____________________________ **Email** ______________________

**DATE**: _____________, 20______, at ______________________________________________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This is an addendum to a rental or lease agreement

1.1 ☐ of same date, or dated _____________, 20______, at ______________________________, California,

1.2 entered into by __________________________________________________________, as the Tenant, and

1.3 ____________________________________________________________________, as the Landlord,

1.4 regarding real estate referred to as ____________________________________________________________

________________________________________________________________________________.

**AGREEMENT:**

In addition to the terms of the above referenced agreement, the undersigned agrees to the following.

**Right of first refusal to buy**:

**2.** Landlord hereby grants Tenant a right of first refusal to purchase the leased premises, for a term commencing _____________, 20______, and expiring ____________, 20______, or ☐ on termination of the right of occupancy.

**3.** Should Landlord decide to sell the premises during the term of Tenant's right of first refusal, Landlord shall notify Tenant of the terms on which Landlord is willing to sell.

3.1 Tenant shall have the option for a period of ______ days after receiving written notice to purchase the premises on terms stated in the notice.

3.2 Should Tenant fail to exercise the option within the option period, Landlord shall have the right to sell the premises to a third party on the same terms stated in the notice to Tenant.

3.3 Any sale on different terms reinstates Tenant's right of first refusal.

**4.** If Landlord has not closed a sale of the property within six (6) months after Tenant's receipt of notice, Tenant's right of first refusal is reinstated.

**5.** ________________________________________________________________________________

________________________________________________________________________________

________________________________________________________________________________

________________________________________________________________________________

**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____________, 20______

Tenant's Name: ______________________________

Signature: ____________________________________

Tenant's Name: ______________________________

Signature: ____________________________________

**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ___________, 20______

Landlord's Name: ______________________________

Signature: ____________________________________

Landlord's Name: ______________________________

Signature: ____________________________________

**FORM 579** 03-11 

The timing of a sale by the use of options and the right of first refusal provisions may reflect:

- the tenant's present inability to buy;
- the tenant's desire to buy;
- the owner's inability to find a buyer; or
- the owner's desire to sell later, not now.

The owner's motives for delaying the decision to sell the leased property when the prospective tenant would rather buy include:

- tax benefits, available by delaying the sale and reporting profit in a year when profit taxes will be lower or the profit can be offset by losses on the sale or operations of other properties;
- financial incentives flowing from delaying the sale to obtain the highest price possible in a rising market, the elimination of neighborhood obsolescence, the re-zoning of the property, or avoiding locked-in financing on property which prohibits a current sale;
- legal problems hindering the sale (and value) of the property, such as a *lis pendens* or toxic cleanup; or
- personal concerns interfering with any desire to sell the property due to health, estate planning or family considerations.

Also, an owner may grant a right of first refusal even though he has no intention of ever selling the property. The tenant may request a right of first refusal on theory that the owner may change his mind or die and the successor will sell.

The right of first refusal serves the same purpose for the owner as an option serves for the tenant — to avoid entering into an enforceable commitment to, respectively, sell or buy real estate.

**Consideration for granting an option**

To create an *enforceable option* to buy or right of first refusal agreement, a condition called *mutuality of obligation* must exist between the owner and the tenant. The owner and the tenant must legally commit themselves to one another in some way before the tenant can enforce the agreement against the owner. [**Kowal** v. **Day** (1971) 20 CA3d 720]

The **owner commits** to be bound by the agreement by **signing** a document granting the tenant the option to buy or the right of first refusal. To create an enforceable option to buy or right of first refusal, the tenant must make a commitment in return. These commitments to one another are called **consideration**.

## Figure 1

**STANDARD OPTION TO PURCHASE**

Irrevocable Right-to-Buy

**Prepared by: Agent** ______________________ | **Phone** ____________________
**Broker** ______________________ | **Email** ____________________

**DATE:** ____________, 20_____, at ______________________________________________, California.

*Items left blank or unchecked are not applicable.*

1. **OPTION MONEY:**
Optionor herewith receives from Optionee option money in the amount of $______________, evidenced by: ☐ cash, ☐ check, or ☐ ________________, given in consideration for this option to purchase real property.
2. **REAL PROPERTY UNDER OPTION:**
Address ______________________________________________
Legal description/Assessor's parcel number ______________________________
3. **ADDITIONAL CONSIDERATION:**
As further consideration for this option, Optionee is to obtain at his expense and deliver to Optionor prior to expiration of this option the following checked items regarding the property:
☐ Property survey report by licensed California surveyors
☐ Architectural plans and specifications
☐ Zoning ordinance request
☐ On-site engineering plans
☐ Application for a parcel map or waiver
☐ Off-site improvement plans
☐ Soil engineer's report
☐ Land use study
☐ Application for a conditional use permit
☐ ______________________________
4. **OPTION PERIOD:**
Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property on the terms stated, for a period commencing with the acceptance of this option and expiring ____________, 20______, or ☐ on termination of the optionee's leasehold interest in the property.
5. **EXERCISE OF OPTION:**
Optionee may exercise this option during the option period by:
5.1 Signing escrow instructions identical in provisions to those attached as **Exhibit A** and delivering the instructions to escrow [See **ft** Form 401];
5.2 Depositing cash in escrow of $______________; and
5.3 Delivering an escrow-certified copy of the signed escrow instructions to Optionor within the option period, in person or by both certified and regular mail.
6. **ESCROW CONTRACT:**
In the event this option is exercised, the transaction shall be escrowed with ___________________________.
6.1 Escrow shall close within ______ days after exercise.
7. **DELIVERY OF TITLE:**
On Optionee's exercise of this option, Optionor shall timely place all documents and instruments into escrow required of the Optionor as necessary for escrow to close as scheduled.
8. **BROKERAGE FEE:**
Optionor agrees to pay a brokerage fee of $____________, or ______% of the selling price, IF:
8.1 This option is exercised;
8.2 Within one year after expiration of option period and any extension or renewal, Optionor enters into an agreement to option, sell, lease or exchange with Optionee, or their assigns or successors; or
8.3 Optionor wrongfully prevents the exercise of this option;
8.4 Payable to Broker(s) ______________________________________________
9. **SALE TERMS:**
Price of $______________ payable as follows:
9.1 ☐ All cash.
9.2 Cash down payment in the amount of $______________.
9.3 ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ____________________, with an unpaid principal balance of $______________, payable $______________ monthly, including interest not exceeding _____%, ☐ ARM, type ______________________, plus a monthly tax/insurance impound payment of $______________. ______________________________
a. At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
b. The impound account to be transferred: ☐ charged, or ☐ without charge, to Optionee.
9.4 ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ____________________, with an unpaid principal balance of $______________, payable $______________ monthly, including interest not exceeding ______%, ☐ ARM, type ________________________, due ____________, 20______.

— — — PAGE ONE OF TWO — FORM 161 — — —

— — — PAGE TWO OF TWO — FORM 504 — — —

5.7 Marketing sessions . . . . . . . . . . $______________
5.8 Travel/hotel . . . . . . . . . . $______________
5.9 Entertainment . . . . . . . . . . $______________
5.10 Insurance (business and health) . . . . . . . . . . $______________
5.11 Total Business Expenses . . . . . . . . . . (–) $______________ ______%

6. **Marketing and Sales Expenses:**
6.1 Printing flyers/mailer for listings. . . . . . . . . . $______________
6.2 Property ads:
a. Newspaper/magazine . . . . . . . . . . $______________
b. TV/radio/web . . . . . . . . . . $______________
6.3 Postage (marketing) . . . . . . . . . . $______________
6.4 Property preparation. . . . . . . . . . . $______________
6.5 Open house (food/drinks) . . . . . . . . . . $______________
6.6 Gifts on closing . . . . . . . . . . $______________
6.7 Transactional expenses . . . . . . . . . . $______________
6.8 Total marketing and sales expenses . . . . . . . . . . (–) $______________ ______%
7. **Agent's Net Income:** . . . . . . . . . . $______________ ______%
7.1 Income, SS & medicare taxes . . . . . . . . . . (–) $______________ ______%
8. **Agent's After-Tax Income** . . . . . . . . . . $______________ ______%
9. **Other Income Sources:**
9.1 Draw/Advance . . . . . . . . . . $______________
9.2 Other ______________________ . . . . . . . . . . $______________
9.3 Other ______________________ . . . . . . . . . . $______________
10. **Cost-of-Entry/Change-of-Office Analysis:**
10.1 Marketing course . . . . . . . . . . $______________
10.2 Lock boxes . . . . . . . . . . $______________
10.3 Open house signs . . . . . . . . . . $______________
10.4 Stationary/cards . . . . . . . . . . $______________
10.5 Computer/programs/printer . . . . . . . . . . $______________
10.6 Office furniture . . . . . . . . . . $______________
10.7 Photocopier . . . . . . . . . . $______________
10.8 Phone/fax equipment . . . . . . . . . . $______________
10.9 Phone installation . . . . . . . . . . $______________
10.10 Camera/printer . . . . . . . . . . $______________
10.11 Vehicle . . . . . . . . . . $______________
10.12 Other ______________________ . . . . $______________
10.13 Other ______________________ . . . . $______________
10.14 **Total Entry/Relocation Costs:** . . . . . . . . . . $______________
11. **Gross Brokerage Fee Projection/Forecast:**
11.1 Annual after-tax income desired by agent. . . . . . . . . . . $______________
11.2 Divide by percentage of after-tax income at §8. . . . . . . . . . . (÷)______________
11.3 Annual Gross Brokerage Fee needed at §1. to earn the desired after-tax income at §11.1: . . . . . . . . . . (=)______________
11.4 Analyze the source of Gross Brokerage Fees at §1 by setting the price of the typical transaction Agent will close, the dollar amount Broker will receive as the Gross Brokerage Fee on the typical transaction, and the number of typical transactions Agent must close within one year to attain the Gross Brokerage Fees set as the goal at §11.3.
______________________________________________
______________________________________________
______________________________________________
______________________________________________.

**FORM 504** 03-11 

When the option or right of first refusal is negotiated concurrently as an addendum to the lease, the **tenant's commitment** is his promise to pay rent and perform under the lease he signs concurrent with receiving the option or right of first refusal.

However, if the option to buy or right of first refusal is later added to an existing lease, additional consideration must be negotiated and delivered to the owner since the tenant is not committing himself to do anything new or different in exchange for the new rights.

Here, the tenant's commitment could be agreeing to a modification of the terms in the existing lease, the settlement of a dispute with the landlord or the payment of a sum of money.

### The option agreement

Under an option agreement, the tenant is not obligated to buy the leased property. The tenant is merely given the right to buy if he so chooses, a type of *call option*.

For the option to be enforceable, the purchase price of the property and terms of payment on exercise of the option must be included in the option agreement. Therefore, if not set as a dollar amount, the purchase price may be stated as the fair market value of the property at the time the option is exercised.

The right to buy must be exercised by the tenant **within a specified time period**, called the *option period*. The option period often runs until the right to occupy (lease) expires or is terminated. [See Form 161 §4]

If the option is not exercised precisely as agreed during the option period, the option period expires of its own accord. Thereafter, the option no longer exists and the tenant has no right to acquire the property. [**Bekins Moving & Storage Co.** v. **Prudential Insurance Company of America** (1985) 176 CA3d 245]

When options to renew or extend are included in the lease, the **expiration** of the option to buy is tied by agreement to either:

- the expiration of the initial lease term; or
- the expiration of any renewal or extension.

For example, a tenant rents space under a ten-year lease with an **option to extend** the term of the lease. The tenant also holds an option to buy the leased property. The option references the lease term — until expiration or termination of the lease — as the period for exercise of the option to buy.

If the lease is later extended, the option period is automatically extended with the **extension** of the lease since the option to buy allows the tenant to exercise the option **during the lease term,** the period of occupancy provided by the lease agreement. [**In re Marriage of Joaquin** (1987) 193 CA3d 1529]

Now consider a lease agreement which contains an *option to renew*, not to extend. The renewal option requires the preparation and signing of a new lease agreement on **identical terms** to the original lease agreement. The initial lease agreement, by way of a referenced attachment, provided the tenant with an **option to buy** which can be exercised prior to the expiration of the lease.

On renewal of the lease agreement, the tenant must ensure the option to buy is not left to expire at the end of the initial lease term. The new lease agreement must also reference the option to buy (as part of the identical terms of the original lease) since a new lease is not an **extension** of the original lease. [In re Marriage of Joaquin, supra]

**Right of first refusal**

To trigger the tenant's right of first refusal, the owner does not need to first agree to sell the leased property by entering into a purchase agreement with another person, with the provision it is "subject to the tenant's right of first refusal."

Any **indication of the owner's decision to sell** the property is sufficient to activate the right to buy, including:

- listing or advertising the property for sale;
- offering the property to a buyer;
- accepting an offer or making a counteroffer involving a buyer; and
- granting a purchase option to another person.

For example, a buyer of income property contacts the owner of leased commercial property to acquire it. The buyer is informed the major tenant holds the right to buy the property under a right of first refusal provision in the lease.

The buyer attempts to circumvent the right of first refusal by negotiating an option to buy the property, exercisable only after the tenant's right of first refusal expires. The owner grants the buyer an option to buy the property. The granting of the option now binds the owner unconditionally to sell the property if the option is exercised.

Here, the owner's granting of the option to sell the property is a clear indication of his intention to sell, triggering the right of first refusal. The tenant is now allowed to purchase the property on the same terms as contained in the option. [**Rollins** v. **Stokes** (1981) 123 CA3d 701]

*Editor's note — The right of first refusal is not triggered by conveyance of the property to the owner's heirs on his death. The heirs take title subject to the right of first refusal. However, the right of first refusal is triggered by a sale of the property ordered by the probate court or entered into by the heirs. To exercise the right of first refusal, the tenant must match the highest offer submitted in open bidding and approved by the court, or the listing or sale of the property by an executor. [**Estate of Patterson** (1980) 108 CA3d 197]*

Once the owner's decision to sell is manifested, the right of first refusal becomes an option to buy. Control of the transaction then passes to the tenant holding the right of first refusal, converting the tenant position under the right of first refusal to that of an optionee.

The owner may not now retract his decision to sell the property without breaching the right of first refusal provision.

**Matching the back-up offer**

The owner subject to a **right of first refusal** held by a tenant is obligated to notify the tenant of the terms of any sales listing, option to buy, offer to purchase, counteroffer or acceptance of an offer to purchase which triggers the tenant's right to buy under the right of first refusal provision.

The tenant must then agree to match the sales terms within the time period set in the right of first refusal provision or he has waived the right to buy for failure to **exercise** the right.

Consider a tenant who holds a right of first refusal on the industrial property he leases.

A buyer makes an offer to purchase the property. The terms for the payment of the price in the buyer's offer include cash and an assumption of the existing first trust deed on the property.

The property is also encumbered with a nonrecourse second trust deed (carried back by a prior owner) to be paid off and reconveyed on closing under the terms of the buyer's offer. The owner accepts the offer and notifies the tenant, giving the tenant the opportunity to match the buyer's offer under the right of first refusal provision in the lease agreement.

The tenant exercises his right of first refusal by agreeing to purchase the property at the same price, but by assuming both the existing first trust deed and nonrecourse second, paying the remainder of the price in cash.

The owner rejects the tenant's conditions and refuses to sell to the tenant.

Here, the owner must comply with the tenant's terms for payment of the price since they are the financial equivalent of the proposed sale. The tenant need merely provide the **same net financial result** to the owner as the offer being matched — a cash-out of the owner's equity in the property.

The tenant's performance under the right of first refusal does not need to be identical in all aspects to the buyer's offer.

Thus, the owner must sell on the tenant's exercise of his right of first refusal since the owner's net proceeds, economic benefits and liabilities resulting from the sale on terms set by the tenant would be the same as those he would experience under the purchase offer which triggered the right of first refusal. [**C. Robert Nattress & Associates** v. **CIDCO** (1986) 184 CA3d 55]

Now consider a buyer who offers to purchase property leased under a right of first refusal held by the tenant. The terms of purchase include a cash down payment and a note executed by the

buyer for the balance of the owner's equity which is secured by a trust deed on other property which has adequate value as security. The owner accepts the offer and notifies the tenant, who agrees to match the buyer's offer.

However, the value of the property offered by the tenant as security is inadequate, causing the owner to refuse to accept it.

Here, due to the inadequate value of the security offered by the tenant for an identical note, the tenant's offer is not **financially equivalent** to the terms of the buyer's offer since the risk of loss on default has been increased.

The landlord is not obligated to accept the tenant's deficient exercise of his preemptive right, which constitutes a waiver of the tenant's right to buy. The owner may now sell the property to the buyer — but only on the same terms. [**McCulloch** v. **M & C Beauty Colleges** (1987) 194 CA3d 1338]

**Reinstatement of the right of first refusal**

A right of first refusal provision automatically carries with it the **reinstatement** of the right when:

- the owner agrees to sell the property on terms different from those terms offered to the tenant; or

- the property remains unsold after the running of an agreed-to period of time following the tenant's waiver of the right to buy. [See Form 579 §4]

Consider an owner who, under a right of first refusal, notifies his tenant of the purchase terms on which he has listed the property for sale. The tenant chooses not to exercise his option to buy at the price and on the terms offered.

The owner later modifies the listing by lowering the sales price or altering the terms for payment of the price.

The price reduction or modification of terms automatically **reinstates** the tenant's right of first refusal obligating the owner to notify of the new terms for purchase of the property. The tenant only waived his right of first refusal for a sale based on the terms originally given to him by the owner, not on the different price or set of terms.

Should a buyer purchase the property on terms other than those offered to the tenant, the buyer takes title subject to the tenant's preemptive right to purchase which is reinstated due to the sale on different terms.

Thus, the buyer must sell to the tenant on the same price and terms he paid since the buyer is on notice of the tenant's rights to acquire the property due to the tenant's possession.

# Chapter 11 An owner's residence in foreclosure

*This chapter examines the equity purchase restrictions which must be known and applied by all investors buying owner-occupied, one-to-four unit residential property during foreclosure.*

***Chapter 11 Outline***

*The equity purchase sales scheme*
*Cancellation within five business days*
*Brokers limited to listing property*
*Broker as principal*
*Representing the seller*
*Two-year right of rescission*
*The unconscionable advantage*
*The un-American low price*
*Structuring the EP agreement*

***Chapter 11 Terms***

*EP disclosure statement*
*EP investor*
*Equitable indemnity*
*Equity purchase*
*Notice of Default (NOD)*
*Oppression*
*Procedural unconscionability*
*Substantive unconscionability*
*Surprise*
*Unconscionable advantage*
*Unconscionability*

**The equity purchase sales scheme**

An *equity purchase* (EP) transaction takes place when an owner-occupied, one-to-four unit residential property in foreclosure is acquired for **rental, investment or dealer purposes** by a buyer, who is called an *EP investor*.

Conversely, an EP transaction does not occur and the EP rules do not apply when the buyer acquires the property for use as his **personal residence** or a lender originates a trust deed loan for the owner-in-foreclosure.

Equity purchase statutes apply to all buyers who are **EP investors** regardless of the number of EP transactions the investor completes.

The investor does not need to be in the business of buying homes in foreclosure for the statutes to apply to him. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

Both the EP investor and his agent must comply with EP law or be subject to drastic penalties.

Also, all agents need to be aware that the EP agreement signed by an EP investor must be printed in **bold type**, ranging from at least 10-point to 14-point font size, and be in the **same language** used during negotiations with the seller-in-foreclosure. [Calif. Civil Code §§1695.2, 1695.3, 1695.5]

Thus, the EP investor and all the agents involved in an EP transaction must use a written agreement containing statutory EP notices. Failure to use the correct forms subjects the EP investor and the agents to liability for all losses incurred by the seller-in-foreclosure, plus harsh penalties. [Segura, *supra*]

*Editor's note — **first tuesday's** Equity Purchase Agreement, Form 156, complies with all statutory requirements and properly sets forth the right of the seller-in-foreclosure to cancel. [See Figure 1, **first tuesday** Form 156]*

**Cancellation within five business days**

Prior to closing an EP sale, the seller-in-foreclosure has a **statutory five-business-day right to cancel** the agreement he has entered into with an EP investor. Thus, the seller can avoid the sale entirely, with or without cause.

The EP investor's compliance with the requirement of a written purchase agreement incorporating the EP rules grants the EP seller the automatic five-business-day right to cancel the agreement before a closing can take place. If the seller cancels within the period, the sale under the purchase agreement cannot be closed.

When the notice of the seller-in-foreclosure's cancellation rights is properly contained in the EP agreement, the seller's **cancellation period ends** at:

- midnight (12:00 a.m.) of the **fifth business day** following the day the seller enters into any type of purchase agreement with an EP investor; or
- 8:00 a.m. of the day scheduled for the trustee's sale, if it is to occur first. [CC §1695.4(a)]

The seller-in-foreclosure's five-business-day right to cancel does not begin until proper notice of the cancellation period is given to the seller by the EP investor. [CC §1695.4(b)]

The first and proper time for giving the seller-in-foreclosure the notice is in the EP agreement. Failure to do so allows the seller to **cancel** the sales agreement and escrow, even to **rescind** the sale after closing, until the notice is ultimately given and the five business days have run without cancellation.

A **business day** is any day except Sunday and the following business holidays: New Year's Day, Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans' Day, Thanksgiving Day, and Christmas Day. Thus, Saturday is considered a business day under EP law, unless it falls on an enumerated holiday. Many state holidays are not included as holidays. [CC §1695.1(d)]

## Figure 1

**EQUITY PURCHASE AGREEMENT**

Prepared by: Agent ____________________ Phone____________________
Broker ____________________ Email ____________________

NOTE: For use by Buyers of one-to-four residential units which are owner-occupied and in foreclosure when the Buyer does not intend to occupy the property. [Calif. Civil Code §1695]

DATE: ____________, 20______, at ________________________________________, California.
*Items left blank or unchecked are not applicable.*

FACTS:

1. Received from ________________________________________, as the Buyer(s),
   - 1.1 the sum of $______________, evidenced by ☐ personal check, or ☐ ____________________, payable to ______________________________, for deposit only on acceptance of this offer.
   - 1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
   - 1.3 situated in the City of ____________________, County of ________________, California,
   - 1.4 referred to as ________________________________________,
   - 1.5 including personal property, ☐ see attached Personal Property Inventory. [See ft Form 256]
2. This agreement is comprised of this six-page form and ______ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of. . . . . . . . . . . . . . . $______________
4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . . . . . . . $______________
   payable approximately $______________ monthly for a period of ______ years.
   Interest on closing not to exceed ______%, ☐ ARM, type ______________.
5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ______________________ with an approximate unpaid principal balance of . . . . $______________
   payable $______________ monthly, including interest not exceeding ______%, ☐ ARM, type ____________________, plus a monthly tax/insurance impound payment of $______________. ________________________________
   - 5.1 The unpaid amount includes delinquent payments, late charges and foreclosure costs to be the responsibility of Buyer in the amount of $______________, including unpaid delinquent monthly payments beginning with the payment due ____________, 20______.
   - 5.2 The impound account to be transferred without charge.
6. ☐ Take title subject to, ☐ or Assume, an existing second trust deed note held by ______________________ with an approximate unpaid principal balance of . . . . . $______________
   payable $______________ monthly, including interest not exceeding ______%, ☐ ARM, type______________, due ____________, 20______.
   - 6.1 The unpaid amount includes delinquent payments, late charges and foreclosure costs to be the responsibility of Buyer in the amount of $______________, including unpaid delinquent monthly payments beginning with the payment due ____________, 20______.
7. At closing, loan balance differences from those stated above as disclosed by beneficiary statement(s) to be adjusted into the purchase price unless the balances exceed the amount stated, in which case the difference is to be adjusted into the cash payment.
8. Assume an improvement bond lien with an unpaid principal balance of. . . . . . . . . . . . . . . $______________
9. Note for the balance of the purchase price in the amount of . . . . . . . . . . . . . . . . . . . . . $______________
   to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due ____________, 20______, after closing.
   - 9.1 This note and trust deed will not contain provisions for due-on-sale, prepayment penalty or late charges.
   - 9.2 Financial Disclosure Statement is attached as an addendum. [See ft Form 300]
10. Total Purchase Price is . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $0.00

*— — — — PAGE ONE OF SIX — FORM 156 — — — —*

*— — — — PAGE TWO OF SIX — FORM 156 — — — —*

11. ACCEPTANCE AND PERFORMANCE:
    - 11.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.
    - 11.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.
    - 11.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.
    - 11.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as ________________________________________.
    - 11.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See ft Form 183]
    - 11.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See ft Form 171 or 172]
    - 11.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.
    - 11.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $______________.
12. PROPERTY CONDITIONS:
    - 12.1 Seller to furnish prior to closing:
      - a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.
      - b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.
      - c. ☐ a one-year home warranty policy:
        Insurer ________________________________________
        Coverage ________________________________________
      - d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.
      - e. ☐ a certification by a licensed contractor stating the sewage disposal system is functioning properly, and if it contains a septic tank, is not in need of pumping.
      - f. ☐ a certification by a licensed water testing lab stating the well supplying the property meets potable water standards.
      - g. ☐ a certification by a licensed well-drilling contractor stating the well supplying the property produces a minimum of ______ gallon(s) per minute.
      - h. ☐ Energy Audit Report stating the rating for the property's improvements is no greater than _______.
      - i. ☐ ________________________________________
    - 12.2 Seller's Condition of Property Disclosure —Transfer Disclosure Statement (TDS) [See ft Form 304]
      - a. ☐ is attached; or
      - b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may either cancel the transaction based on a reasonable disapproval of the disclosure or deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance. [See ft Form 269] Seller to repair, replace or correct noticed defects prior to closing.
      - c. On Seller's failure to repair, replace or correct noticed defects under §12.2b or §12.4a, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See ft Form 183]
    - 12.3 Seller's Transfer Fee Disclosure Statement [See ft Form 304-2]
      - a. ☐ is attached; or
      - b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Withing ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Transfer Fee Disclosure.
      - c. Seller to pay any transfer fees arising out of the transaction.

*— — — — PAGE TWO OF SIX — FORM 156 — — — —*

## Figure 1

— — — — — — — — — — — — PAGE THREE OF SIX — FORM 156 — — — — — — — — — — — —

12.4 Buyer to inspect the property twice:

a. an initial property inspection is required on acceptance to confirm the property's condition is substantially the same as observed by Buyer and represented by Seller or Seller's Agents prior to acceptance, and if not substantially the same, Buyer to promptly notify Seller in writing of undisclosed material defects discovered. [See ft Form 269] Seller to repair, replace or correct noticed defects prior to closing; and

b. a final walk-through inspection is required within five days before closing to confirm the correction of any noticed defects under §12.2b and §12.4a and maintenance under §12.14. [See ft Form 270]

12.5 Seller's Natural Hazard Disclosure (NHD) Statement [See ft Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of Buyer's post-acceptance receipt of the NHD, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the Statement and unknown to Buyer prior to acceptance. [See ft Forms 182 and 183]

12.6 Buyer acknowledges receipt of a booklet and related seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978 one-to-four units) [See ft Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960 one-to-four units). [See ft Form 315]

12.7 The property is located in: ☐ an industrial use area, ☐ a military ordnance area, ☐ a rent control area, ☐ airport, farmland, San Francisco Bay or mining operation area, see attached Notice Addendum [See ft Form 308] or ☐ ________________________

12.8 On acceptance, Seller to hand Buyer the following property information for Buyer's review: ☐ Property Expense Report [See ft Forms 306], ☐ ________________________

a. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of the property information received.

12.9 If a Homeowners' Association (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed, copies of the association's: 1) Articles of Incorporation, 2) CC&Rs, 3) Bylaws, 4) operating rules, 5) age restriction statement, 6) operating budget or summary, including reserve study, 7) assessment and reserve funding disclosure statement, 8) CPA's financial review, 9) assessment enforcement policy, 10) insurance policy summary, 11) regular assessment, 12) special assessment, 13) emergency assessment, 14) other unpaid obligations of seller, 15) approved changes to assessments, 16) settlement notice regarding common area defects, 17) preliminary list of defects, 18) notice(s) of violation, 19) required statement of fees, 20) minutes of regular meeting of the board of directors conducted over the previous 12 months, 21) transfer fee.

a. Association claims for property defects or changes in regular or special assessments ☐ are or ☐ are not pending or anticipated. Current monthly assessment is $______________.

b. Seller is not in violation of CC&Rs, except ________________________.

c. Seller to pay association document and transfer fees. [See ft Form 135]

d. Buyer to approve the association's statement of condition of assessments and confirm representations in subsection 11.9a above as a condition for closing escrow.

e. Within ten days of Buyer's post-acceptance receipt of the association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See ft Form 183]

12.10 Seller's Neighborhood Security Disclosure [See ft Form 321]

a. ☐ is attached, or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

12.11 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.12 If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §§25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

12.13 Possession of the property and keys/access codes to be delivered: ☐ on close of escrow, or ☐ as stated in the attached Occupancy Agreement. [See ft Forms 271 and 272]

12.14 Seller to maintain the property in good condition until possession is delivered.

— — — — — — — — — — — — PAGE THREE OF SIX — FORM 156 — — — — — — — — — — — —

— — — — — — — — — — — — PAGE FOUR OF SIX — FORM 156 — — — — — — — — — — — —

12.15 Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.16 Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with ________________________.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See ft Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See ft Form 401]

13.2 Escrow to be handed all instruments needed to close escrow on or before ___________, 20______, or within _____days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary Escrow charges. [See ft Forms 310 and 311]

13.3 The amount of any taxes, liens, bonds, assessments or other encumbrances on the property not referenced are, at Buyer's option, to remain of record and be deducted first from the cash payment and then from any carryback note.

13.4 Buyer's title to be subject to covenants, conditions, restrictions, reservations and easements of record.

________________________.

13.5 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by ________________________ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements ________________________

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.6 Buyer to furnish a new fire insurance policy covering the property.

13.7 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

13.8 Bill of Sale to be executed for any personal property being transferred.

13.9 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See ft Form 183]

14. Buyer's Broker and sales agent hereby confirms under penalty of perjury that:

14.1 ☐ he holds a valid, current California real estate license;

14.2 ☐ he has provided proof of his license to the seller-in-foreclosure by attaching:

a. ☐ a copy of his license as issued by the DRE; or

b. ☐ a printout of the DRE's Current License Status for the licensee; and

14.3 ☐ he holds adequate coverage via bond, errors and omissions insurance, or whatever other means which may become required by Equity Purchase laws.

15. FURTHER CONDITIONS: ________________________

________________________

________________________

— — — — — — — — — — — — PAGE FOUR OF SIX — FORM 156 — — — — — — — — — — — —

## Figure 1



16. **NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:**

**California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.**

**The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.**

**If you have any questions concerning this matter, please call your local Tax Collector's Office.**

17. BROKERAGE FEE:

17.1 Parties to pay the below mentioned Broker(s) a fee now due of ____________________ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

17.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee ________:_________.

17.3 Attached is the Agency Law Disclosure. [See ft Form 305]

17.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

18. CANCELLATION PERIOD:

18.1 Seller has the below noticed right to cancel this agreement until midnight of the fifth business day following the day Seller signs this agreement, or until 8 a.m. on the day scheduled for a trustee's foreclosure sale of the property, whichever occurs first.

**NOTICE REQUIRED BY CALIFORNIA LAW:**

**Until your right to cancel this contract has ended,**

**__________________________________________________(Buyer)**

**or anyone working for**

**__________________________________________________(Buyer)**

**CANNOT ask you to sign or have you sign any deed or any other document.**

**You may cancel this contract for the sale of your house, without any penalty or obligation at any time before ______:_____, ______.m. on _____________, 20______.**

**See attached Notice of Cancellation form for an explanation of this right.**
**(To be filled out by Buyer)**

| Buyer's/ Selling Broker: ____________ | Seller's/ Listing Broker: ____________ |
|---|---|
| Broker's DRE Identification #: ____________ | Broker's DRE Identification #: ____________ |
| Selling Agent: ____________ | Listing Agent: ____________ |
| Agent's DRE Identification #: ____________ | Agent's DRE Identification #: ____________ |
| Signature: ____________ | Signature: ____________ |
| Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer. | Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer. |
| Address: ____________ | Address: ____________ |
| Phone: ________ Cell: ________ | Phone: ________ Cell: ________ |
| Fax: ____________ | Fax: ____________ |
| Email: ____________ | Email: ____________ |

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| I agree to the terms stated above. | I agree to the terms stated above. |
|---|---|
| ☐ See Signature Page Addendum. [ft Form 251] | ☐ See Signature Page Addendum. [ft Form 251] |
| Date: ____________, 20______ | Date: ____________, 20______ |
| Buyer: ____________ | Seller: ____________ |
| Signature: ____________ | Signature: ____________ |
| Buyer: ____________ | Seller: ____________ |
| Signature: ____________ | Signature: ____________ |

**NOTICE OF CANCELLATION**
**(To be filled out by Buyer)**

Seller signed the Equity Purchase Agreement on ____________, 20______.

You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before ______:______, ______.m. on ____________, 20______.

To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to ______________________________________________(Buyer)
at ______________________________________________(Business Address)

NOT LATER THAN ______:______, ______.m. on ____________, 20______.

I hereby cancel this transaction.

Date: ____________, 20______

Seller's Signature: ______________________________

Seller's Signature: ______________________________

**NOTICE OF CANCELLATION**
**(To be filled out by Buyer)**

Seller signed the Equity Purchase Agreement on ____________, 20______.

You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before ______:______, ______.m. on ____________, 20______.

To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to ______________________________________________(Buyer)
at ______________________________________________(Business Address)

NOT LATER THAN ______:______, ______.m. on ____________, 20______.

I hereby cancel this transaction.

Date: ____________, 20______

Seller's Signature: ______________________________

Seller's Signature: ______________________________

Until expiration of the right of the seller-in-foreclosure to cancel the transaction, the EP investor may not:

- **accept or induce a conveyance** of any interest in the property from the seller;
- **record any document** regarding the residence signed by the seller with the county recorder;
- **transfer an interest** in the property to a third party;
- **encumber any interest** in the residence; or
- **hand the seller** a "good-faith" deposit or other consideration. [CC §1695.6(b)]

However, escrow can be opened on acceptance, and deeds and funds deposited with escrow, since the seller-in-foreclosure is not delivering a conveyance (to the buyer) and will not receive funds until the close of escrow.

In negotiations with the seller-in-foreclosure, the EP investor, as with any buyer or agent, may not make false representations or misleading statements about:

- the value of the property in foreclosure;
- the net proceeds the seller will receive on closing escrow [See **first tuesday** Form 310];
- the terms of the purchase agreement or any other document the EP investor uses to induce the seller to sign; or
- the rights of the seller in the EP transaction. [CC §1695.6(d)]

**Cancellation** of the purchase agreement by the seller-in-foreclosure is **effective on delivery** of the signed written notice of cancellation to the EP investor's address in the purchase agreement. [CC §1695.4(b)]

When the EP investor receives the seller-in-foreclosure's written notice of cancellation, he must return, without condition, any original contract documents, such as the EP agreement bearing the seller's signature, to the seller within ten days following receipt of the notice. [CC §1695.6(c)]

Accordingly, the EP investor should not place funds in escrow before expiration of the cancellation period and a request for funds is made by escrow since an EP investor is not permitted to couple the release of funds to the return of documents on cancellation.

When the cancellation period expires for lack of a cancellation, the purchase agreement becomes enforceable and escrow can be closed, unless other contingencies exist.

**Brokers limited to listing property**

Equity purchase (EP) legislation regulates brokers when they act as a **buyer's agent** for EP investors who attempt to buy an owner-occupant's home that is in foreclosure.

The broker **representing an EP investor** must, when negotiating an EP transaction, deliver to all parties to the transaction a written *EP disclosure statement* that the buyer's agent representing the EP investor is a **licensed** real estate broker.

The broker must also provide **proof of licensure** to the seller-in-foreclosure showing the broker holds a current, valid California real estate license. [CC §1695.17(a)]

If the buyer's agent fails to deliver either the **EP disclosure statement** or the proof of licensure to the relevant parties, the EP agreement is **voidable** at the discretion of the seller any time before escrow closes.

Also, the EP investor is liable to the seller-in-foreclosure for any **losses arising** out of the buyer's agent's nondisclosure of licensing requirements. [CC §1695.17(b)]

However, the EP investor would be entitled to *equitable indemnity* from his agent, a reimbursement for the seller's losses caused by the agent's nondisclosure. **Equitable indemnity** is available to the EP investor who, without active fault on his part, is forced by legal obligation to pay for losses created by his agent's nondisclosure. [**San Francisco Examiner Division, Hearst Publishing Company** v. **Sweat** (1967) 248 CA2d 493]

**Broker as principal**

The EP legislation does not restrict the ability of an individual, who may coincidentally be licensed as a broker or sales agent, to act solely as a **principal** purchasing property as an investor in an EP transaction.

Thus, a licensed real estate broker or agent may himself be the EP investor, eliminating use of the agency law disclosure as well as avoiding licensee disclosure and proof requirements. The licensed real estate broker or agent, acting solely as an EP investor, is a buyer who merely happens to hold a real estate license — a fact which does not need to be disclosed to the seller-in-foreclosure since the licensee is not also acting as an agent for anyone in the transaction.

Conversely, if a real estate broker **employed** as the listing broker by a seller-in-foreclosure decides to directly or indirectly buy his client's property, he **must disclose** to his seller-client that he is **also acting as a principal** in the transaction. [Calif. Business and Professions Code §§10176(d), 10176(g), 10176(h)] **Representing the seller**

Prudent brokers and agents are inclined not to solicit or accept an exclusive right-to-sell listing from a seller-in-foreclosure. Property in foreclosure must be sold and escrow closed before the date of the trustee's foreclosure sale to have fully performed the employment and be entitled to a fee.

Unless the delinquent loan is brought current prior to five business days before the trustee's sale or paid in full before the sales date, the home will be sold at the trustee's sale. [CC §§2924c(e), 2903]

The seller's agent for a seller-in-foreclosure usually needs extra time to find a buyer and close escrow since the frequency of foreclosures is inversely related to the volume of sales. The time constraints imposed on the seller's agent by a trustee's sale date, before which the seller's agent must close any sale of the property, place extra pressure on the broker employed under an exclusive listing agreement to locate a buyer.

As always, the seller's agent acting under an exclusive listing must perform his agency duties owed the seller by properly marketing the property with care and diligence. As a further complication, the seller-in-foreclosure expects the broker to save his equity by negotiating a sale of the property and closing escrow before the property is lost to the foreclosing lender.

If the insolvent seller loses his equity, he may claim a lack of due diligence or unprofessional conduct on the part of the broker to locate a buyer and close an escrow — a risk the broker and his agents take when listing a home which is in foreclosure.

**Two-year right of rescission**

A *Notice of Default (NOD)* is recorded on a homeowner's personal residence after several months of unpaid installments.

The homeowner, now in foreclosure, is willing to sell on almost any terms to salvage his remaining credit and equity in the property.

The property is listed with a broker. The broker's seller's agent markets the property primarily to buyers who will occupy the property as their personal residence.

However, an offer is submitted directly to the seller-in-foreclosure by an EP investor, acting on his own account, without broker representation. Under the EP offer, the seller-in-foreclosure will receive cash for his equity. Additionally, the EP investor will cure the seller's loan delinquencies.

The seller-in-foreclosure contacts his listing broker who, after reviewing the offer, recommends the seller accept the EP investor's offer and, if an acceptable backup offer is received within the cancellation period, accept the backup offer and cancel the EP agreement.

The agent advises his client he has five business days after his acceptance of the EP offer to cancel the sale since the sale involves the seller's home, which is in foreclosure.

The seller-in-foreclosure accepts the EP investor's offer. The five-day cancellation period expires without receiving a backup offer and escrow is opened on the EP agreement. The EP transaction is later closed and the property conveyed.

Does the EP investor receive good title when he accepts the grant deed?

No! The EP investor's title remains subject to the seller-in-foreclosure's right of rescission for two years after closing. If at any time during the two years following the close of escrow and the recording of the grant deed conveyance the seller believes the **EP investor's conduct** and the **price paid** gave the EP investor an *unconscionable advantage*, the seller may attempt to rescind the transaction and recover the home he sold. [CC §1695.14]

**The unconscionable advantage**

The two-year rescission period only allows a seller-in-foreclosure to recover property if he can demonstrate the EP investor took **unconscionable advantage** of him when negotiating the purchase of the property.

Showing the existence of an unconscionable advantage in the **EP investor's conduct** is problematic for both the seller-in-foreclosure and the EP investor. The legislature has not defined what exactly constitutes an act of unconscionable advantage by the buyer.

What was a reasonable sales price under the circumstances surrounding the seller-in-foreclosure when the transaction was entered into might appear to be unconscionable to the seller in the future due to market factors and inflation, not the conduct of the EP investor. Thus, an EP investor assumes the risk that a rising economy may provoke the seller into attempting to rescind (for the wrong legal reason).

If real estate values rise rapidly and significantly, the "greed factor" may set in, turning a formerly desperate seller-in-foreclosure into an astute rescinding seller.

However, any increase in the value of the property after acceptance of the EP investor's offer may not be considered. The test of unconscionable advantage is not based on events occurring after the seller-in-foreclosure enters into the purchase agreement.

Market circumstances existing at the time of the negotiations or when the parties entered into the agreement are the economic considerations which form one of the two elements for testing unconscionable advantage. [**Colton** v. **Stanford** (1890) 82 C 351]

*Unconscionability* has two aspects:

- the lack of a **meaningful choice** of action for the seller-in-foreclosure when negotiating to sell the home to the EP investor, legally called *procedural unconscionability*; and

- a purchase price or method of payment which is **unreasonably favorable** to the EP investor, legally called *substantive unconscionability*.

The **price paid**, like any other provision in a purchase agreement, can be considered unconscionable. When determining the unconscionability of the purchase price, justification for the price at the time of the sale and the terms of payment will be examined.

An **unconscionable method of payment** could include:

- carryback paper with an unreasonably low interest rate, long amortization or a due date on the note that bears no relationship to current market rates and payment schedules; or

- an exchange of worthless land, stock, gems or zero coupon bonds at face value with a 20-year maturity date.

A form of payment which is uncollectible, unredeemable and with no present value would be unconscionable.

However, the existence of unreasonable pricing and payment alone is not enough to show the unconscionable advantage needed to rescind a closed transaction. Both the lack of a **meaningful choice** and **unreasonably favorable** (advantageous) terms must exist to show **unconscionability** existed.

**The un-American low price**

Any procedures used or conduct employed by an EP investor as a misfeasance or misrepresentation made to deprive the seller-in-foreclosure of a reasonable choice between the EP investor's offer and offers from other buyers must exist to establish the lack of a meaningful choice or alternative to the EP investor's offer.

An **unconscionable advantage** occurs if the EP investor exploits an element of *oppression* or *surprise* and exacts an unreasonably low and favorable purchase price or term of payment.

**Oppression** by the EP investor exists when the inequality in bargaining power between the investor and the seller-in-foreclosure results in no real negotiations between them — a "take it or leave it" environment deliberately removed from competing buyers. The foreclosure environment itself often presents a one-sided bargaining advantage for the EP investor to exploit should he decide he does not want his offer "shopped around" and used to solicit a better deal from other buyers during the five-business-day cancellation period.

**Surprise** occurs due to the post-closing discovery of terms which are hidden in the lengthy provisions of the agreement. The price and how it will be paid is not a surprise. The price is well known to the seller-in-foreclosure and, on any rescission action by the seller, will likely be the only term of the agreement contested by the seller.

The greater the marketplace oppression or post-closing surprise discovery in the transaction, the less an unreasonably favorable price paid by an EP investor will be tolerated. [**Carboni** v. **Arrospide** (1991) 2 CA4th 76]

**Structuring the EP agreement**

An investor, not intending to be an owner-occupant buyer, wants to purchase single family residences (SFRs) for investment purposes.

The investor locates an owner-occupied SFR encumbered by a trust deed on which a Notice of Default (NOD) has been recorded, commencing a trustee's foreclosure.

Because the seller occupies the residential property and an NOD has been recorded, the investor realizes he must comply with California's EP laws when preparing and submitting an offer to purchase the property.

The EP investor is willing to purchase the SFR for a price of $140,000 on the following terms:

- **pay** $10,000 cash to the seller-in-foreclosure for his equity in the property;
- **take over** the existing loan with a total of $130,000 due the lender in unpaid principal, delinquent installments and foreclosure costs; and
- **pay** the delinquent installments of principal, interest, taxes and insurance (PITI) and the foreclosure costs of approximately $7,400 — all of which are included in the $130,000 owed the lender on the loan.

The EP agreement calls for a $10,000 cash down payment. [See Form 156]

Also, the EP investor will take title to the property "subject to" the existing first trust deed with a 28-year amortization remaining.

The conditions of the trust deed note are:

- $122,600 of remaining principal (after the delinquent payments have been brought current);
- 6.5% interest;
- $802.30 monthly principal and interest payments;
- $150 monthly taxes/insurance impounds payments;
- current five month delinquencies on PITI of $4,761.50; and
- foreclosure costs of $1,316.80.

The first trust deed is a loan insured by the Federal Housing Administration (FHA) subject to the Department of Housing and Urban Development (HUD) due-on-sale rules controlling investor purchases. However, only HUD, not the lender, has the right to call a HUD-insured loan. The likelihood of HUD calling any loan which is kept current is remote. Thus, the loan may be taken over by the EP investor "subject to" minimal interference from the lender, i.e., assumption fees and loan modification are avoided.

The seller-in-foreclosure will not be carrying back a portion of the purchase price since this is a cash-to-loan transaction.

As an alternative method for payment of the purchase price, negotiations could have included provisions for the seller to carryback paper in the EP transaction.

The seller-in-foreclosure is five months delinquent in payments. The EP investor will bring the $4,761.50 in delinquent PITI payments current, which includes $326.66 in principal reduction.

Taxwise, the payment of the delinquent principal and interest (PI) payments (not the impounds) is part of the EP investor's original **costs of acquisition**. The interest paid by the EP investor which accrued **before acquiring** the property is an expense of the seller-in-foreclosure, not the EP investor. Thus, the payment of the seller's debts must be capitalized by the EP investor as part of his cost basis in the property. [Internal Revenue Code §1012]

The EP investor's cost basis on acquisition of the property will be the purchase price of approximately $140,000, which includes the seller-in-foreclosure's delinquent PI installments, foreclosure costs and the principal balance on the loan, less the impound account balance.

A prudent EP investor will determine the total cash funds needed to close escrow before making an offer. **Cash expenditures** of the EP investor on closing include:

- a down payment of $10,000.00;
- delinquent principal, interest, taxes and impounds of $4,761.50;
- foreclosure costs of $1,316.80;
- escrow fees and charges of $300.00; and
- a total cash investment of $16,378.30.

# Chapter 12 To default, or not to default

*This chapter digests contemporary attitudes toward mortgage default and turns a critical eye to the social consequences and economic impact of a strategic default.*

***Chapter 12 Outline***

*Emotions and irrational disbeliefs about losing a home*
*Heading underwater and toward insolvency*
*Moral prognosticators*
*The Fed's hoped-for result vs. competitive advantage*
*Cramdowns are the solution*
*Proposition 13*
*Stay and pay or walk straight away*
*What to expect from the unmotivated lender*

***Chapter 12 Terms***

| | |
|---|---|
| *Financial accelerator event* | *Nonrecourse* |
| *Loan-to-value ratio (LTV)* | *Proposition 13* |
| *Millennium Boom* | *Put option* |
| *Negative equity* | *Strategic default* |

**Emotions and irrational disbeliefs about losing a home**

Traditionally, a mortgage lender's underwriting practice requires a homeowner to inject sufficient equity into his home in the form of a **down payment** to ensure the buyer views payment of the mortgage as necessary to protect the equity in the home: a safeguard against default.

However, as lenders moved toward less restrictive credit risk models in the mid-2000s, they relied increasingly on credit scores (and fast rising value of the collateral) to gauge borrower fitness and propensity to repay debts.

Thus, the down payment and property qualification took a back seat to the credit score as a measure of loan qualification. Lenders based this decision to go exclusively with the credit score upon studies which show that borrowers with optimum and medium credit scores have a 0.9% and 4% chance of default, respectively.

For instance, during the *Millennium Boom*, many buyers with optimum credit scores were not asked to make a down payment to qualify for mortgages with **loan-to-value ratios (LTVs)** of

100% or more. Both lenders and Wall Street bond dealers (along with their rating agencies) thought the fast-rising prices of real estate would more than make up for the lack of a down payment.

They methodically created a future equity spread in the home as collateral to ensure that homebuyers had an incentive to pay, thanks to the initial non-existent disparity between the amount of the mortgage and the value of the home. However, permitting LTVs above the traditionally safe 80% threshold became common practice during the five-year **Millennium Boom** which preceded the *Great Recession* of 2007-2009.

The fallout from this **Ponzi scheme** in homeownership left California's real estate market unsteady even through the end of 2011. The state had not yet recovered from the swift evaporation of mortgage lenders and the lending that was a bellows to the conflagration of home ownership statewide.

### Heading underwater and toward insolvency

All this structure fell apart when Wall Street lost the means to issue bonds to fund mortgage lenders and their borrowers. Many homebuyers with upper-echelon credit scores who bought during the boom were then stranded in homes worth far less than the mortgage, a condition called *negative equity*, more colorfully referred to as being "**underwater**."

What are underwater homeowners to do? The logical choice for many distressed owners who are employed is a *strategic default*. This is especially relevant in California, a **nonrecourse state** where more than a quarter of homeowners had negative equity exceeding 25% of their home's value in the early 2010s, disqualifying them for a loan modification.

But if **strategic default** is the perfectly rational, legal and financially beneficial choice, why are so few doing it?

In a paper titled *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis,* the forces pushing homeowners against the tide of logic and influencing them to keep paying their distressed, dead-end mortgages are detailed by Brent T. White of the University of Arizona College of Law.

The social control mechanisms White discusses are:

- the emotional desire to avoid *shame and guilt*; and
- the fear of adverse *financial consequences* due to a foreclosure.

His point is well taken and widely observable. There is no shortage of seemingly authoritative voices extolling the responsible homeowner and his ethical duty to pay (no matter the debt amount). Representatives of the federal administration in 2009 advised that the upstanding, moral choice for homeowners is to "stay and pay," essentially to do good so the lenders do well.

Previously, the U.S. Treasury accused nonpaying homeowners of failing to honor a “moral obligation” to pay.

### Moral prognosticators

What should be a personal financial decision has become a talking point for moral prognosticators. There is **no moral obligation** to pay that any lender in California can enforce; only **legal obligations** exist in housing contracts. For the past 75 years, since the 1930s dawn of nonrecourse anti-deficiency laws in California, the lender has been legally barred from obtaining a money judgment against a homeowner for his failure to pay on a purchase-assist mortgage, economically called a *put option*.

Contained in all trust deeds, the **put option** can also be seen as a means of holding lenders' feet to the fire: make sure the risk is sound when the mortgage is originated or end up with a deed-in-lieu, or worse.

To judge the credit crisis and the epidemic of negative equity a “moral crisis” and an “ethical failing” on behalf of homeowners is to lose sight of the nuance of fault. While some buyers are guilty of biting off more house than they could chew (or agreeing to too great a price), the vast majority of homeowners carrying negative equity do so as a result of the poorly managed national mortgage market.

### The Fed’s hoped-for result vs. competitive advantage

Wall Street failed to regulate itself the way the Federal Reserve, Congress and the White Home believed (or hoped) it would. Like rickety scaffolding, a systemically corrupt credit rating system was constructed to package mortgage-backed bonds (MBBs) of dubious ratings, based on ever-rising home prices and borrower credit scores rather than the more reliable 80% LTV.

Aided by the U.S. Treasury's 9/11-influenced decision to constantly look backward in an effort to keep rates low, lenders were able to produce reams of mortgages to feed the avaricious Wall Street bankers who bought and peddled the paper into the bond market.

Despite clear and damning evidence of systemic failure and analytical corruption throughout the U.S. banking and financial systems (conditions that paved the way for the mortgage and housing crisis), distressed homeowners remain the politically popular party to blame (together with mortgage loan brokers and appraisers as lobbied by lenders through Congress) for the negative equity epidemic. Thus, homebuyers and refinancing homeowners are forced to passively shoulder a disproportionate amount of fault.

### Cramdowns are the solution

Modifying underwater mortgages by a *cramdown* of the principal balance should be a lender's “logically beneficial and morally responsible” response to a crisis which they alone facilitated. However, lenders and loan servicers have deliberately avoided calls to meaningfully modify bad loans.

Interestingly, the mortgage documentation prepared by the lender and signed by the borrower contains a contractual **put option,** granting forgiveness of the loan debt in exchange for delivering the property – title and possession – to the lender. Thus, lenders are legally bound to accept the property in lieu of payment whereas homeowners have a choice to either pay the loan and keep the property or default as an exercise of their option to force the lender to take the property.

It is not as if lenders were ignorant of the deteriorating state of the nation's mortgage market, or had zero warning. As with all experts, many homeowners and individual investors on Wall Street relied on financial professionals to be in-the-know about the health of the mortgage market.

But as the housing and the financial system were being run into the ground (in tandem) by lousy underwriting standards and the observable build-up of extreme regional and huge national housing bubbles, these professionals sounded no alarms and took no preventative steps. Rather, homeowners were offered first and second mortgages at 125% the value of their homes — homes that would lose tens (and in California, hundreds) of thousands of dollars in value in a matter of two years.

To illustrate the point, take the fictional couple in White's paper: Sam and Chris. They purchased their three bedroom home in Salinas, California for $585,000 in January 2006 (the average price of a home of this size in Salinas in 2006). The couple had optimum credit scores, reliable income and qualified for a fixed rate (6.5% APR) loan with zero down, giving them a total monthly payment of $4,300, or just shy of 31% of their gross monthly income. With two children, the couple barely made ends meet to cover expenses and pay a mortgage on their first home.

Traditional underwriting standards would have required the couple to make a down payment of about 20% of the value of the home, bringing the LTV to 80%. During the boom, however, borrower fitness was evaluated based on credit scores.

The LTV of the couple's home in 2006 was 100%. Prices of homes peaked in Salinas and throughout all of California in the first quarter of 2006.

With the beginning of the **Great Recession** in December 2007, the housing market fell apart and Sam and Chris still owed about $560,000 on their home. However, as of the third quarter of 2009, their home was only worth about $187,000 (according to data from Zillow.com). A comparable sale in the neighborhood puts the actual market price of their home at about $179,000 with nearby homes renting for about $1,000 per month. What is the couple to do?

Assuming the couple intends to stay in their home until their children finish at the local high school (ten years from now), Sam and Chris would save approximately $340,000 by walking away. On the other hand, if the couple sticks with their $560,000 mortgage, it would take over 60 years for the home to resurface from its current point of negative equity, appreciating at its historical trend-line rate of 3.5%.

## Proposition 13

But these numbers do not fully represent the hit to property taxes taken by property owners with underwater homes as a result of California's **Proposition 13**.

For Sam and Chris, Prop. 13 tags a base year value (the price at the time of purchase) at $585,000 and taxes are 1% of the assessed value of the home with increases in assessed value pegged to inflation and capped at 2% per annum. For Sam and Chris, the breakdown occurs thus: from 2006 to 2007, the assessed value of the couple's home increased by 2% to $596,700 and increased again by 2% from 2007 to 2008. There was a very small increase in the value from 2008 to 2009 of .06% causing the assessed value of the couple's home to top out at $609,000 for 2009.

With the Prop. 13 tax schedule in place, based on the price they paid at the top of the boom market, Sam and Chris are on the hook to pay a bill of 1% of the $609,000 assessed value of the property for 2009. However, $6,090 is 3.4% of the $179,000 market value of their home.

Of course Sam and Chris could petition for a reassessment of the value of their home to current market prices, but as soon as real estate prices begin an upward trajectory (albeit meagerly this time around), they will once again pay an annually compounded 2% on top of their 2006 $585,000 base year assessment.

Alternatively, the couple could **walk away,** buy a replacement home of comparable quality to the one they own and save big on costs and taxes over time. Further, to walk away now would allow for the California recovery to take place much sooner since money that would otherwise be sunk into an underwater property (between $3,500 and $4,000 per month in this scenario) would be injected into local, regional and state economies through purchases, allowing individuals like Sam and Chris to provide their families an overall better quality of life and higher standard of living.

Like more than a third of U.S. homeowners, Sam and Chris are faced with two choices: they can either continue paying the dead-end loan, lugging the negative equity of their home as an albatross around their necks for the rest of their lives, or default and save hundreds of thousands of dollars. Nationwide, only 3% of underwater homeowners strategically default and lenders know this fact.

**Stay and pay or walk straight away**

But many more homeowners should be walking away to build up their valuable retirement savings and improve their living conditions for which credit is not important. When viewed as a scenario afflicting 2.5 million California homeowners, couples like Sam and Chris who "stay and pay" impede the state's job recovery.

Despite the preponderance of evidence to the contrary, society's arbiters of political and public opinion demand homeowners flog themselves for their poor decisions by paying their underwater mortgages to defend the lenders from loss and insolvency. The government calls for homeowners to remember their moral or ethical obligations, never suggesting that we are a country of laws which guarantee a legal result.

A contributing factor are fellow citizens who continue to make the irrational decision to continue paying their mortgages then righteously demand justice for homeowners who decide not

to pay. Thus, any homeowner searching for answers or help from among his peers is met mostly with shame, fear-mongering and disinformation, keeping distressed and ill-informed homeowners in a **financially catatonic** state.

In one corner, we have the lenders who made terrible decisions in their risk assessment of homebuyers and homeowners and the excessively credit-driven economy of the 2000s, the insidious *financial accelerator event*. They are fighting to recover the money they lent the homeowner. In the other corner, we have the California homeowner who – encouraged by government subsidies and homeownership slogans which are framed and guided by mortgage lenders, builders and brokers – signed a note for more than 100% of the value of his home.

What is a nation thus divided to do?

### What to expect from the unmotivated lender

Lenders have reacted unfavorably to struggling homeowners. They have shown less courtesy and willingness to mediate than is warranted, considering the homeowner's option to **strategically default**.

A homeowner contacting his lender who actually gets in touch with a helpful customer service representative is frequently told he must default before the lender will help, a move deliberately intended to leave a blemish on the homeowner's credit score before mediation can begin.

Next, after defaulting as instructed, the homeowner is threatened with foreclosure if he does not pay late fees and past due amounts. Only after those amounts are paid (or more frequently added to the loan balance) will the lender agree to a common loan modification plan (read: scam); and such plans tend to be anything but helpful.

The scam is referred to as "**extend and pretend**," and initially appears to be helpful to the homeowner since his monthly payment is lowered. However, each monthly payment made by the homeowner is only allocated to a portion of the interest due on the loan, which eventually adjusts upward to fully amortize the loan. At the end of the modification, the homeowner will be right back where he started, only years in the future.

Thus, the lender takes money from the homeowner during the temporary modification period (extending his stay in the home) and the lender pretends to help, but is really playing a money-making trick on the distressed and emotional homeowner.

Additionally, most of these homeowners end up defaulting again when the installment payments reset to an amount higher than before the modification.

The intelligent move would be to stop paying, wait for the foreclosure sale, then pack up and pay rent elsewhere until the crisis has passed, since a re-default on a modified loan equals a double hit on their credit score. Besides, making timely payments on rent, utilities, credit cards and a car loan will repair the defaulting homeowner's credit rating within a couple of years or more for scores that were previously perfect.

Coupled with a *letter of explanation* about the sole cause of the blemish (default), the homeowner's credit score will absolutely weather the financial crisis — especially if the homeowner's job remains intact and he pays all other debts as agreed. [See **first tuesday** Form 217-1]

A study cited by White's paper shows a defaulting homeowner can most often secure new lines of credit in as little as **18 months** after default. Even the Federal Housing Administration (FHA) will insure a loan to a **bankrupted homeowner** after only two years. Besides, the cash savings derived from defaulting will mitigate any future need for credit.

With prior planning for the financing of purchases to be made during the period prior to defaulting, the homeowner avoids the credit score penalties lenders so want imposed on defaulting homeowners.

All things considered, a temporarily damaged credit score should be the least of a distressed homeowner's concerns.

Over time, negative equity is far more damaging to a family than losing a home to foreclosure or taking a temporary hit to one's credit rating. Credit heals and can be rebuilt quite quickly under a single event blemish, but supporting a negative equity property compounded by lost savings in this zero sum game equals a prolonged retirement age (if ever) and decades of struggling to "get by."

Imagine watching a neighbor purchase a new car, make repairs to his home or send his children to college while the underwater homeowner is never fully able to enjoy his property, living one large unforeseen expense away from financial ruin.

With lenders refusing to aid the over-encumbered homeowner and the federal government reticent to enact effective measures while intimidating homeowners into paying, the rational choice is to walk away.

# Chapter 13 — How to facilitate a shortsale transaction

*This chapter describes the short selling process as an alternative to foreclosure, and details how to qualify a negative-equity homeowner for a short payoff, set the sales price at the broker price opinion (BPO) and submit a purchase agreement to the lender's loss mitigation officer for appraisal and closing conditions.*

***Chapter 13 Outline***



***Chapter 13 Terms***

*Authorization to release information*
*Broker price opinion (BPO)*
*Comparative market analysis (CMA)*
*Discharge-of-indebtedness*
*Fair Isaac Corporation (FICO)*
*Fair market value (FMV)*
*Hardship letter*
*Home Affordable Modification Program (HAMP)*
*Loss mitigation specialist*
*Short payoff*

## The discounted payoff from start to finish

Consider an unemployed homeowner who misses a monthly mortgage payment. The homeowner's lender contacts him as mandated regarding the delinquency and discusses the homeowner's financial situation. Unable to make payments and desperate to avoid the personal onus of a **foreclosure**, he solicits the help of a **real estate agent**.

Before meeting with the homeowner, the agent downloads a "property profile" (title condition) for the home and a printout of recent sales in the surrounding area from a title company website, the first step in any seller counseling and listing effort. The agent, on review of the reports, comes to a preliminary opinion of the property's *fair market value (FMV)* — a *broker price opinion (BPO)* — he will use to set the listing price.

However, he quickly notes the mortgage on the property is an amount that greatly exceeds the property's value, a *negative equity* situation. His prospective seller is thus "underwater."

The meeting between the homeowner and the agent focuses primarily on the homeowner's inability to clear title of the lender's trust deed and close escrow on a sale of the property at current prices.

The agent advises the homeowner that to avoid a foreclosure by selling the property himself he must consider negotiating for the lender to accept the net proceeds from a sale of his home in full satisfaction of his mortgage debt — a discount called a *short payoff*.

**Enter the short payoff**

The homeowner decides he would rather sell the home than allow it to go to a foreclosure sale. Either way, the homeowner understands he will net nothing from the sale but will pay nothing to live in the property until the property is sold. While a **loan modification** is discussed, the unavailability of a **principal reduction** rules out that option.

The agent advises the homeowner he will not have to vacate until:

- a shortsale closes, which will take roughly three to six months after a buyer's purchase offer is submitted to the lender; or

- a foreclosure sale is held, around ten months after missing his first payment.

The owner and the agent enter into a **listing agreement**, pricing the property at the BPO set by the agent. The agent adds a provision to the listing agreement stating:

> *"The owner will first qualify with the mortgage lender for a discounted payoff of the loan and reconveyance of the trust deed on a sale of the home at which time the agent will begin marketing the property in search of a buyer."* [See **first tuesday** Form 102-1]

The agent instructs the owner to contact his lender and discuss how to proceed with an agent on a shortsale.

On contacting the lender, the owner is referred to the lender's **loss mitigation specialist**, sometimes called a *negotiator*. In response, the owner is sent a shortsale information packet, requesting he deliver the following to the lender:

1. **Authorization to release information to an agent**. This document signed by the homeowner gives his lender permission to deal with and furnish information about the mortgage to the homeowner's real estate agent. Without this authority, lenders will not communicate with anyone acting on behalf of his homeowner, making the document one of first priority. [See **first tuesday** Form 124]

2. **A hardship letter.** In order for the lender to determine whether or not the homeowner is financially qualified to make payments on the mortgage, the homeowner prepares a letter detailing his current personal and financial situation. The homeowner explains he was laid off and has not been able to find a new job. He also discloses he is the only wage earner in his household. [See **first tuesday** Form 217-1]

3. **His most recent pay stubs, bank statements and tax returns**. The lender wants to confirm the homeowner is purchasing only necessities in lieu of making mortgage payments (i.e. groceries, car repairs and school supplies). Tax returns are used to verify annual income. Often the lender will also require the owner to fill out a financial statement (equivalent to an application for a loan) to determine whether the owner has other assets available as a source of funds to pay off the mortgage without a discount (i.e. cash on hand, equity in other property, stocks/bonds, etc.).

4. **Proof of occupancy**. The homeowner provides the lender with a utility bill in his name at the property address to prove he occupies the residence and doesn't rent it to others.

Unless the homeowner is **financially unqualified** to pay the mortgage and foreclosure on the property is inevitable, a lender will not agree to a discounted payoff of the loan.

**Have you qualified your homeowner?**

After the lender receives and reviews the completed documents from the homeowner, the homeowner will be advised whether the lender will consider a **short payoff** if he sells the property. If advised he qualifies for a shortsale, the homeowner will be able to obtain a reconveyance of the lender's trust deed lien and close escrow on a sale. Of course, the agent will need to generate an offer at a price with net sales proceeds the lender will actually accept in full satisfaction of the loan.

*Editor's note —When a buyer's agent finds a property listed as a shortsale, the first question he must ask the seller's agent is* ***"Have you qualified your homeowner for a shortpay with his lender? If not, why not?"***

*Buyer's agents have a limited role in the shortsale process, but they must — on behalf of their buyer — confirm with the seller's agent on a shortsale listing that the homeowner has been qualified for a shortpay with his lender. As a comparison, a seller's agent does not take a buyer seriously who has not been pre-approved for purchase-assist financing by a lender.*

*In the same way, a buyer's agent must protect his buyer, along with everyone's time and energy, by being assured the seller has been qualified for a shortpay with his lender before spending any additional time putting together an offer from his buyer.*

Once a purchase offer is received and accepted by the seller, it is submitted to the lender for consideration. An appraisal is then ordered by the lender to determine the **FMV** of the property — the acceptable sales price in the eyes of the lender.

If the appraisal is at or below the sales price, the lender will likely indicate the buyer's offer is sufficient and orally agree to accept the net sales proceeds and reconvey its trust deed on the close of escrow. If the appraised value is greater, the lender will likely indicate the sales price must be set at the appraisal amount before they will consent to a discounted payoff — the short payoff.

**The solvent but underwater homeowner's story**

Now consider a homeowner who has the financial ability to make his monthly mortgage payments. He has multiple investments and a steady job, but his home has a **loan-to-value (LTV) ratio** higher than 125%. Thus, he owes more to his lender than his home is worth, making it an underwater asset, commonly called a *negative-equity property*.

Wishing to dispose of the home and rid himself of his excessive mortgage obligation, the homeowner approaches a real estate agent for advice on the best way to get out from under his financial mess. The agent explains lenders will not discuss a short payoff with anyone who still makes his monthly mortgage payments. A homeowner must first default and take damage to their credit score before a lender will even consider negotiations.

The homeowner further inquires about the lender's likely reaction if the homeowner intentionally stops making mortgage payments in order to open discussions about a short payoff.

Although a default in payments is the homeowner's first step in getting the lender's attention to begin the shortsale process, a defaulting homeowner must also meet **financial incapacity** standards and have endured a significant hardship (in the opinion of the lender). Lenders (and Congress) do not consider owing more on a mortgage than the home is worth to be a hardship.

If a homeowner is financially able to make payments or owns other valuable assets, it is highly unlikely a lender will qualify him for a short payoff and agree to take a loss on that mortgage – other than through a foreclosure sale/**real estate owned property (REO)** situation.

Rather than have the homeowner trudge through this tedious process only to be rejected, it may make more sense for a homeowner who wants to rid himself of a **negative-equity property** to exercise his *put option* contained in the lender's trust deed.

To do so, he *strategically defaults*, thus forcing the lender to sell the home at a foreclosure sale which automatically eliminates the mortgage debt.

According to a study by the *Fair Isaac Corporation (FICO)*, a foreclosure has the **same effect** on an **underwater homeowner's** credit score as a shortsale. Also, **FICO** scores damaged by either a shortsale or a foreclosure sale have the same estimated recovery time.

In this destabilized real estate market, brokers and their agents don't have the time, money or talent to waste marketing a negative-equity property whose owner fully qualifies to borrow the principal amount remaining on the mortgage. A seller's agent can make a quick assessment of whether or not a shortsale will ever be approved by:

- investigating the property's title conditions;
- working up a **Comparative Market Analysis (CMA)**;
- initially setting a BPO; and

- analyzing the seller's financials (balance sheet and income analysis).

Although agents do not generally receive a fee for giving advice to **strategically default**, (but properly may as an unlicensed financial consultant) they will save themselves months of wasted effort by moving on to more promising listings.

**Tax aspects of the short payoff**

Taxwise, the two most significant consequences of a shortsale of an owner-occupied one-to-four unit residential property encumbered by a purchase-assist loan, improvement loan or **refinance** on a purchase-assist loan — called a *nonrecourse loan* under *California anti-deficiency law* — are:

- the shortsale does not trigger tax reporting of ordinary income for the discounted and discharged portion of the loan if the home is sold on or before December 31, 2012; and

- the discount on a short payoff produces a capital loss that cannot be used to reduce taxable income.

The discount on a short payoff is not to be reported by the seller as **discharge-of-indebtedness** income, and instead produces a "personal loss" (capital loss) on the sale that cannot be written off. However, the lender will file a 1099C indicating the discount occurred, reporting it as debt relief that is otherwise taxable except for the negative equity home sales rule. [Internal Revenue Code §108(e)]

**California anti-deficiency laws** prevent a lender from collecting any amount from a homeowner beyond the net proceeds on a short payoff, or the amount received at the foreclosure sale of the property.

*Editor's note — When processing a short payoff, some homeowners are asked by the lender to contribute cash in addition to the net sales proceeds of their home before they will reconvey their trust deed lien.*

*Homeowners confronted with this lender demand after entering into a shortsale purchase agreement with a buyer must understand they cannot legally be required to throw their reserves into a transaction that has already damaged their credit — by design of the lender — and will further damage it on closing as though a foreclosure sale had taken place, whether or not they add cash to close a negative equity sale.*

*If the lender fails to accept the net sales proceeds in full settlement of the debt and the buyer will not pay the amount demanded by the lender, a homeowner with a purchase-assist mortgage needs to then consider his right to cancel the sales transaction and let the lender foreclose on the property.*

*This* ***strategic default*** *requires no out-of-pocket cash from the homeowner nor can the lender collect any deficiency in the property value from the homeowner. A second trust deed complicates the liability analysis as seconds are recourse paper, unless the second trust deed lender gives written consent to a shortsale.*

**Shortsale alternatives**

If a homeowner wants or needs to get out of his home, a short payoff is just one of many options he can investigate.

Unsurprisingly, lenders are leaving negative-equity homeowners with very few routes to take. Nationally, banks modified only 558,000 mortgage loans in the first half of 2011 when delinquencies were rising – a 42% decrease from the 968,000 modifications made in the first half of 2010.

A modification is rarely an escape from the burdens of an excessive mortgage since on modification the principal is rarely reduced. In fact, the principal is almost always increased during a loan modification, leaving the owner with a worse LTV than before.

The government's attempt to persuade lenders to modify more loans through the *Home Affordable Modification Program (HAMP)* has proven vastly ineffective. For negative equity homeowners in California with their excessive LTVs, a meaningful loan modification is nothing more than a short-lived dream.

Likewise, any rumors of modifications granting principal reductions to correct jacked-up LTVs have proven false. Lenders know agreeing to a cramdown for one homeowner means all homeowners will expect the same treatment.

If they refuse short payoffs for most negative equity homeowners who want out of their properties, there is no way they will shed the debt of that 90% of homeowners who faithfully make payments and still want to keep their homes.

We've said it for years and its worth repeating once more: at the behest of the banks, employed underwater homeowners are left with no other choice than a strategic default. A strategic default allows a homeowner to both move on to another residence and increase his family's standard of living – things very American to do.

Until lenders muscle up or are forced to report their mortgage losses, the real estate market will continue to heave under the disproportionate weight of delinquencies, foreclosures and REO inventory.

Until then, lenders will be too suppressed with foreclosure-related activities and solvency issues to lend.

# Chapter 14 Qualifying a negative equity homeowner for a shortsale

*This chapter examines the process of qualifying a negative-equity homeowner for a shortsale with his mortgage lender's loss mitigation officer.*

***Chapter 14 Outline***

*The new and present normal, sort of*
*An uphill battle*
*Before you take a listing, do the math*
*A different lender holds a second*
*Keep an eye on your buyer*
*Further delay for HAFA benefits*
*HAFA qualified*

***Chapter 14 Terms***

| | |
|---|---|
| *Anti-deficiency law* | *Lesser Depression* |
| *Home Affordable Foreclosure-Alternatives (HAFA)* | *Lien* |
| *Home Affordable Modification-Program (HAMP)* | *Short payoff* |
| | *Short Sale Agreement (SSA)* |

**The new and present normal, sort of**

The **shortsale** has resurfaced to again become a commonplace feature of the home resale market in the wake of the **Lesser Depression** brought on by the dire job environment. Hundreds of thousands of California homeowners have no sufficient financial means to keep paying on the mortgages encumbering their **negative equity properties**, a requisite condition for a lender's consent to a short payoff.

Roughly **one in six** multiple listing service (MLS) sales transactions statewide today is a shortsale **—** the result of the financial fallout of the massively inflated real estate prices of the past decade and the current lack of job opportunities for unemployed or underemployed homeowners.

Homeowners looking to enter into and close a sale based on a short payoff of the mortgage must:

- be delinquent on their mortgage payments;
- owe more than their property is worth, the *negative equity condition*; and

- no longer qualify to pay on the mortgage based on assets and debt-to-income (DTI) ratios.

These **unemployed** and underemployed casualties of our ongoing Lesser Depression often view a short payoff as the respectable alternative to losing their home through a **foreclosure** sale.

To accomplish their shortsale objective, they fully expect even an inexperienced agent with **"shortsale training"** seminars under his belt to properly structure the listing and purchase offers, as well as successfully negotiate with the lender to get rid of both the house and the mortgage debt.

However, agents confronted with a potential listing of a negative equity property find that lenders prefer foreclosures over short payoffs since foreclosures:

- delay the reporting of their loan losses (which short payoffs do not);
- avoid discounting loans on payoff in situations where the seller is fully qualified to make payments or the property value is deemed greater than the price the seller has agreed to accept; and
- quell their fears that homeowners are taking advantage of them (thus creating a moral risk) by receiving an unwarranted discount.

**An uphill battle**

For these reasons, negotiating with a lender for a short payoff is not a straight-forward or routine task. Any agent facilitating a shortsale by handling negotiations with the homeowner's lender needs to first thoroughly understand:

- **California anti-deficiency law** barring lender collection of property value deficiencies on purchase-assist mortgage foreclosures and short payoffs [See **first tuesday** Real Estate Finance Chapter 43: *Anti-deficiency: past, present and future*];
- the **trust deed foreclosure** process and documentation, as well as time periods for reinstatement and redemption prior to the trustee's sale and elimination of ownership [see **first tuesday** Real Estate Finance Chapter 47: *Trustee's foreclosure procedures*];
- complications over clearing the title of any **junior financing** encumbering the property in situations where the amount of the first is either less or more than the shortsale net proceeds;
- pricing in a shortsale purchase agreement must be at or above the **fair market value (FMV)** of the property as set by the lender's appraiser;
- the **Home Affordable Foreclosure Alternatives (HAFA)** application process if the homeowner is eligible to receive government-funded relocation funds;

- lender documentation to confirm the homeowner is qualified for a discount (unqualified to pay) before they will consent to a short payoff; and
- their homeowner's income and net worth financial situation.

This knowledge combined with recent first-hand experience acquired acting as a seller's agent and actually negotiating short payoffs with a lender is the pedigree of a "shortsale specialist."

**Before you take a listing, do the math**

Only 19% of shortsales homeowners enter into with buyers in Southern California actually close. Agents who struggle to get listings and earn fees are tempted to take any shortsale listing that comes across their desk. However, a **short payoff** listing becomes a massive waste of time, effort and goodwill if the lender is not going to consent to a discount.

The lender's consent is based on facts readily available to the seller's agent at the time the listing is being negotiated. Thus, an agent's forward-oriented investigation can anticipate lender approval or rejection before taking the listing and conserve the agent's time, talent, reputation and money. For agents, a basic litmus test to discern which shortsale listings are worth the time begins by asking the following questions:

*Is the mortgage's LTV ratio more or less than 94%?*

If a homeowner owes less than the home is worth (read: the loan-to-value ratio (LTV) is less than 94%), the lender will not agree to a short payoff – the net sales proceeds are more than enough to pay the loan in full (but they may permit a few thousand dollars be paid to a second trust deed holder for his reconveyance).

*How many liens are on the property?*

The seller's agent needs to determine whether any **junior liens** encumber the property since each lender must be dealt with to clear title of their **trust deed** lien before a shortsale can be closed.

Occasionally, the same lender holds both the first and second mortgage on a home, the piggy-back financing of the **Millennium Boom**. Holding all the liens on the property, the lender will handle negotiations as though one amount was owed them.

If they qualify the homeowner for a shortsale, the lender receives the net sales proceeds from a further-approved shortsale in full settlement of the combined debts.

**A different lender holds a second**

If a lender other than the first trust deed lender holds the second mortgage, one of two situations exists:

- the net sales proceeds satisfy the first trust deed, but not the second; or

- the net sales proceeds do not satisfy the first trust deed, and by extension do not satisfy the second.

In the first fact situation, the net sales proceeds are more than sufficient to fully satisfy the first trust deed on closing. In this situation, the seller's agent negotiates solely with the junior trust deed holder(s) — seeking their consent to accept the balance of the net proceeds remaining (after paying the first trust deed lender, who has priority to the funds) as the short payoff and satisfaction in exchange for a reconveyance of their trust deed.

Here, the second lender — not the first — is initially contacted when taking the listing to qualify the seller for a short payoff of the second. If the second concludes the seller qualifies for a discounted payoff, then the purchase agreement entered into by the seller is submitted to the second lender for shortpay consent (together with a HUD-1 estimated closing statement).

At that point, the second lender orders out the appraisal, determines the property value and reviews the appropriateness of the net sales proceeds before allowing the shortsale to close by discounting the amount owed them.

The second fact situation is traumatic for everyone involved in clearing title: the homeowner, the seller's agent and both lenders. Here, the seller's agent has to deal with both lenders. The second trust deed lender will demand some amount of money from the net sales proceeds before they will consent to cancel their debt and reconvey their trust deed lien.

As a result, the seller's agent will need to be **sufficiently innovative** to set the stage at the outset of negotiations. To begin, the first must understand the second must be dealt with if the first is to be paid off by a shortsale. Thus, the first must agree to let the second participate for a few thousand dollars in the net sales proceeds, which firsts have learned to understand.

Then negotiations with the second lender must keep the second from being so greedy (they have nothing to lose) as to kill the transaction. At all times agents need to resist any requests by the lenders for the brokers to cut their fees agreed to in the purchase agreement. [See **first tuesday** Form 150-1]

**Keep an eye on your buyer**

The processing times on the lenders' end vary widely. The typical shortsale takes three to five months, but any one of many factors involved can deny the seller's agent success.

On the other end of the deal, the length and uncertainty of a short payoff transaction often triggers a buyer's decision to withdraw their offer or just abandon it as hopeless. Buyers and buyer's agents are too often left "out of the loop" during the shortsale process. To keep the deal alive, buyers must be given frequent updates to ensure the process is on the right track and moving. Although buyer's agents have no contact with the loss mitigation specialist during the shortsale process, they must stay in contact with the seller's agent, say weekly, for status updates to be passed on to the buyer.

Frustrated buyers and those who locate and purchase other property cancel or abandon their purchase agreements during the approval process. Loss of the buyer nullifies all the work done

by the lender. On the seller's acceptance of another buyer's purchase offer and submission of documentation to the lender for approval, the loss mitigation specialist assigned to the file starts the approval and appraisal process all over again (as does HAFA).

**Further delay for HAFA benefits**

The shortsale process is often delayed by yet another monkey wrench – HAFA money for the seller. The government's HAFA program is aimed at helping homeowners avoid foreclosure. It is a supplement to the **Home Affordable Modification Program (HAMP)** rolled out in spring of 2009.

HAFA provides incentives for homeowners, lenders and agents to consider a shortsale rather than a foreclosure sale. Homeowners participating in a HAFA shortsale receive:

- $3,000 to help cover their cost of relocation;
- full release from future deficiency liability for the first mortgage (as cash contributions are not allowed in a HAFA transaction); and
- standard timeframes for each step of the process.

Lenders participating in a HAFA shortsale receive:

- $1,500 to cover administrative costs; and
- up to $2,000 for allowing a total of $6,000 in net sales proceeds to be distributed to junior lienholders.

Agents representing a homeowner in a HAFA shortsale receive fee protection since lenders are prohibited from requiring a reduction in a real estate fee agreed upon in the listing agreement (up to 6%).

In order for a homeowner to be eligible for HAFA:

- the property must be the homeowner's principal residence;
- the mortgage must be a first lien originated before January 1, 2009;
- the mortgage must be delinquent or default must be imminent;
- the current unpaid principal balance must be equal to or less than $729,750;
- the homeowner's total monthly mortgage payment must exceed 31% of his gross income; and
- the homeowner must first apply for a loan modification through HAMP.

Lenders must consider a HAMP homeowner for HAFA within 30 calendar days after the homeowner:

- fails to successfully complete a trial period under a HAMP modification;
- misses at least two consecutive payments after a HAMP modification; or
- requests a shortsale or deed-in-lieu of foreclosure.

**HAFA qualified**

If a homeowner requests shortsale consent from their lender after all HAFA qualifications have been met, their lender sends them a HAFA *Short Sale Agreement (SSA)* to be signed by the homeowner and real estate agent within **14 calendar days** of receipt. The SSA is then returned to the lender's loss mitigation specialist. [See HAFA Form 184]

The lender gives the homeowner an initial period of **120 calendar days** to sell their home after receipt of the signed SSA, which can be extended up to 12 months (during which time period the owner is making no payments as the owner pays no rent). Once an offer to purchase the home is accepted, the homeowner (or his agent) must submit a Request for Approval of Short Sale (RASS) to the lender within **three business days** after executing a purchase agreement, including:

- a copy of the purchase agreement and all addenda;
- buyer documentation of funds or pre-approval from a lender; and
- information on the status of subordinate liens and any negotiations with subordinate lienholders. [See HAFA Form 185]

After receiving the RASS, the lender approves or denies the request within **ten business days**.

This separate HAFA application, documentation and processing time is completed before the lender even begins its own shortsale approval process, creating a delay of around three months.

If the lender refuses to approve the transaction for a short payoff after HAFA approves the owner for a shortsale, the transaction with the buyer is terminated unless somehow revived by negotiations to resolve the lender's reasons for disapproval of the shortsale.

If the sale is terminated, the HAFA process starts all over again for this seller (and the seller's agent) when the next buyer's shortsale purchase offer is accepted.

# Legal Aspects

# Chapter 15 Securities aspects of syndication

*This chapter discusses the securities risks that exist in real estate development, lending and business operations co-owned as group investments.*

***Chapter 15 Outline***

*Economic risks of real estate excluded*
*Existing asset vs. securities risks*
*Protecting the investor*
*Controlled investments*
*Subdivided parcels sold to groups*
*Risk capital tests*
*Personal use coupled with development*
*Promised returns without development*
*Exemptions when securities risks exist*
*Disclosure of securities and limitations on recovery*

***Chapter 15 Terms***

*Horizontal commonality investment*
*Non-public offerings*
*Pooling arrangement*
*Rental pooling*
*Rental pooling agreement*
*Risk capital test*
*Securities risk*

**Economic risks of real estate excluded**

When a group of investors are brought together by syndication, whether structured to own real estate as a limited liability company (LLC) or other form of co-ownership — tenancies-in-common (TICs), corporations, limited partnerships (LPs), etc. — the syndicator must have an understanding of the social purpose underlying state and federal securities laws if he is to avoid **promotional activities** controlled by securities law.

The classic federal definition of a security relationship is:

- an **investment** of money;
- a **common enterprise** based on the mutual success or failure of the group in its investment goals; and

- an **expectation of profits** produced by the **efforts of others**, not just by the property. [**Securities and Exchange Commission** v. **W. J. Howey Co.** (1946) 328 US 293]

In application, the purchase and ownership of real estate by any group of investors involves both the elements of an **investment** and a c**ommon enterprise**. Thus, the syndicator's formation of a group for an investment in real estate has the potential for creating a *securities risk.*

However, to create a security, the investment program must contain the third element — profit that is produced by others through an activity that creates value in the property. A securities risk arises when the investor releases control of his cash contribution, and it remains under the syndicator's or someone else's control until the promised value-creating activity is completed.

The risk created by a person's promise to perform an activity that creates value in a property is distinguished from a group investment that does not present a securities risk and remains outside the securities law.

To be a security, the investment program sold to the group of investors must provide for a **return of the original investment** based on a promise, by the syndicator or someone else, of future physical development or other change of use for the real estate acquired, that must be completed before the investment goal can be attained.

However, the mere formation of a group of investors by a syndicator to purchase and operate an existing income-producing real estate project for income, or hold land for profit on resale, does not involve a **securities risk**. Here, the expectation of a return is based on the performance of the property in the marketplace, subject to economic conditions that affect all properties. The investors are not counting on the efforts of the syndicator or any other person to produce improvements or to develop a use for the property after the invested money has been released from the investor's further control.

Also, LLC ownership is merely a **business structure** used as a form of group ownership of the asset acquired in a real estate investment program. Thus, soliciting and offering cash investors fractional membership interests in an LLC (or as tenants in common) formed to fund the acquisition of an existing income- producing property is not, without analyzing other activities in the investment program, the offering of a security.

Conversely, an investment group formed to develop real estate or undertake an ongoing resale marketing program, farming operation or business opportunity, regardless of the entity or form of vesting chosen for the group, contains securities risks. To create a corporate securities risk the investors' capital must be placed at a **risk of loss** through the need to complete significant value-adding activities after the acquisition of the property.

Also, the selection by the syndicator of a property for acquisition after the investor relinquishes control of his cash, called a blind pool, is an activity controlled by the securities law.

A group investment program containing an activity that constitutes a securities risk imposes a duty on the syndicator soliciting investors' capital to comply with the securities law. Exemptions exist that remove some investment programs containing securities risks from control under the securities law.

Unless exempt, the syndicator first reports to the appropriate government agency:

- the California Department of Corporations (DOC) to comply with state securities rules (to qualify for a permit); or

- a registration with the Securities Exchange Commission (SEC) to comply with federal law.

Failure to qualify or register the sale of non-exempt corporate securities exposes the syndicator who creates the securities risk to civil and criminal liability.

A prudently selected property in a structured investment program avoids ownership activities that place the investors' capital at a risk of loss, such as after-closing development, blind pool asset selection, or collective post-acquisition coordination with others (rental pooling). These ownership activities create a relationship between the investors and the syndicator, or others, that is classified as a corporate security.

**Existing asset vs. securities risks**

A group of investors purchases a newly constructed, but unoccupied apartment building. The syndicator who solicited the investors to become co-owners serves as manager for the group and the property. The investors have the right to cancel the property management agreement with the syndicator by removing him as the manager on 30 days' notice (or less).

The investment program eventually fails to be a financial success. The local economy and its exploitation by the syndicator does not produce enough tenants to occupy the property. Thus, the amount of rental income received is insufficient to pay operating expenses and installments on the purchase-assist loan. The investment fails and is liquidated by foreclosure or other sale.

The co-owners make a demand on the syndicator for a return of their investment funds, plus the legal rate of interest (10%). They claim the purchase of the complex, when coupled with the property management agreement, creates a corporate security that was neither exempt from the securities law nor qualified by the DOC. The co-owners claim they relied on the syndicator's **management expertise** to rent out units in the newly constructed building and create a **return on the capital** they invested in the LLC.

Does the syndicator who merely manages property in competition with other like-type properties impose a liability on himself for the return of the co-owner's capital?

No! A corporate security is not created by the existence of property management activity or the promise or expectation of an annual return on their investment. Members of an LLC or TIC **retain control** over the management of the property. They have the right to terminate any

property management agreement and the manager by a vote of the co-owners. Further, they can replace management with other management, a service readily available in the local brokerage community.

Here, the investors did not place their capital at risk in reliance on the skill and effort of another to **create value** in the property. Instead, they acquired a fully improved, existing asset in exchange for the funds invested, on the chance the rental market place will allow their investment to prosper.

Also, they retained ultimate control over management since they could change management at any time. The investors bought the property, not the syndicate manager or his management expertise (which was, instead, the subject of the property management agreement), as the investment. [**Fargo Partners** v. **Dain Corp.** (8th Cir. 1976) 540 F2d 912]

Now consider a syndicator who sells small parcels of agricultural land planted with citrus trees to individual investors. Under a **service agreement** attached to each purchase agreement, the syndicator is to care for the trees and harvest and market the fruit produced by all the properties under his management. The term of the service agreement is 10 years.

The syndicator manages the groves on all the separate parcels by coordinating the ownership and operations of all the parcels as a single, large-scale farming operation. The syndicator has the knowledge and equipment required to conduct a successful farming operation and **produce and sell** the crop. Each investor is to receive a share of the net operating income from the syndicator's crop production based on their pro rata ownership of all parcels farmed under the service agreement, called a *pooling arrangement* or *horizontal commonality investment*.

In contrast to an apartment building co-owned by several investors with the syndicate manager locating tenants and renting existing units, an investment in a parcel of agricultural land operated as a farming business, coordinated and managed by the syndicator or others, contains a corporate securities risk. The investors rely solely on the expertise of the syndicator to **create a return** of their invested funds (capital) by **producing a crop**, then harvesting and selling it. As a further securities risk, he agreed to do so in cooperation with owners of other properties in a **pooling arrangement**.

Here, an investor who cancels the service agreement with the syndicator will not be able to independently operate his parcel of land and its grove with any economy to be successful. Operating separately from the owners of other parcels he will not be able to readily hire another operator to coordinate farming operations with the owners of other parcels as a **collective** to produce and market crops. The **financial success** of the operation requires all the parcels in an economy of scale to be operated as one, using special equipment and skills possessed by the syndicator.

Thus, even though the transaction was structured as a sale of a parcel of real estate to an individual purchaser combined with a service agreement, the series of related transactions display the critical elements of a corporate security — a group investment with an expectation of profits and success inextricably interwoven with the efforts of others to **produce a crop** and market it to generate an income and, ultimately, a return of the investment. [W. J. Howey Co., *supra*]

## Protecting the investor

The state and federal corporate securities laws exist to protect investors who risk their capital in **asset-creating investment schemes** offered by others. The social purpose is to give investors a reasonable opportunity to realize profits on their investment.

A securities risk is created under California securities law whenever:

- an investor places his funds at risk of loss; and
- assumes a passive role, giving control of essential asset selection, development, pooling or resale decisions exclusively to the syndicator or others.

A security is created when the syndicator or others promise to perform an activity that **creates value** after the close of the purchase. Unless the creative activity is completed successfully, value will not be added to the property and the expected return of capital will not occur.

In essence, the investor did not invest in an existing asset, but in the skill of someone else to create that valuable asset in the future. The expenditure of invested funds is no longer controlled by the investor, but by the syndicator or others. Activities that occur after closing and create a **securities risk** include:

- locating and selecting a property for acquisition, called a *blind pool*;
- obtaining government approval or permits for zoning or a higher and better use of the property;
- making further improvements or significant alterations to the property; or
- operating a business or farming operation that requires expenditures for inventory, production or sales.

Thus, for a security to exist, the syndicator must undertake an ongoing investment activity that continuously places the investor's capital at risk of loss until the promised value-adding activity is completed. The securities risk is contained in the management of money, whether obtained from the investors or borrowed funds, to improve the property, create the crop or obtain agency approvals for a new use to fulfill the purpose of the group investment.

Examples of activities that include a securities risk for investors in syndicated real estate transactions include:

- subdividing, improving or reselling the real estate (dealer activities);
- operating a business on the premises acquired rather than merely managing the rental of the real estate or the ownership of vacant land; and
- investing in trust deed notes.

The California securities law is designed to give investors a fair chance of realizing investment objectives promised to be performed and completed by others. The syndicator is responsible for returning the investor's capital if promises of development are not fulfilled by completing after-closing activities that create the significant value necessary to provide for a return of the investors' contributions. [**Silver Hills Country Club** v. **Sobieski** (1961) 55 C2d 811]

**Controlled investments**

The securities issue for the syndicate manager is to determine which investment activities include risk situations that trigger the application of the securities law.

The existence of a security is a matter of the substance of the transaction, not the form it has been given. The economic function of the transaction, rather than the title the transaction bears or the type of business form used, determines whether a securities risk exists.

*Editor's note — An exception to the substance-over-form rule is the issuance of stock. Any transaction that involves the issuance or transfer of investment certificates, which are formally called stock, is a controlled security, regardless of the economic substance of the investment in the "stock." [**Landreth Timber Company** v. **Landreth** (1985) 471 US 681]*

For example, the citrus grove investment program reviewed above was structured as a sale of a parcel of improved agricultural property. Each investor became the sole owner of an individual parcel of land — a real estate sales situation that, without further development after the acquisition, does not contain a securities risk.

However, each owner has no reasonable ability to **independently control** or operate the property and produce and market a crop in the farming business they bought into. Success was entirely in the hands of the syndicator to create value for a return of their invested funds through the husbandry, production, marketing and sale of the crop, and the coordination by pooling with other owners.

Next, consider an investor who purchases a condominium unit through a real estate broker. Normally, the purchase of a residential unit does not constitute a corporate security (other than as controlled by the subdivision law.) However, the broker also arranges for the buyer to enter into a *rental pooling agreement* (RPA) with a vacation rental management company for the ongoing operation of the property. The broker has no connection to the management company employed in the **RPA** and receives no kickback or fee for the referral.

Under the RPA, the management company oversees a rental operation within the entire project in which the investor's unit is located. The property manager distributes spendable rental income to the investors of individual units based on their pro rata share of ownership participation in the RPA, not based on the actual performance of their separate units, an activity called *rental pooling*.

The RPA is a major inducement for the investor to purchase the condominium unit. The pooling arrangement enables him to locate tenants, rent the unit and collect rental income without being personally responsible for the day-to-day management of his unit. Critical to the investment is

the sharing of these investment risks; he will share the income and expenses with everyone else within the "pool." More strategically, the investor plans to cover his monthly mortgage payments and assessments on the condominium out of the rental income.

Ultimately, due to market forces, not management, the unit fails to produce the level of rental income the investor expected. The investor seeks to recover his investment from the broker, claiming the purchase of the condominium coupled with the RPA was a corporate security, since the investor relied on the management efforts of others in the **joint operation** of several individually owned units to produce a return of his investment.

The broker claims he did not create a corporate security since the investor was not required to enter into the RPA as part of the agreement to purchase the condominium. Further, the broker was not in control of the management of the property.

Did the broker create a corporate security by arranging an RPA for the investor?

Yes! The purchase of the condominium unit coupled with the RPA was presented to the investor as two separately controlled components of a single investment scheme. The investor was induced by the broker to invest his funds in the common enterprise based on an **expectation of profits** produced by the efforts of others in a pool and split program — even though the broker himself was not the person responsible for coordinating the rental pooling effort.

Since the broker arranged for the investor to place his funds at risk on the close of escrow in anticipation of a future return generated by the efforts of others — the pooling and management of several separately owned properties under the RPA — a securities risk was created. [**Hocking** v. **Dubois** (9th Cir. 1989) 885 F2d 1449]

**Subdivided parcels sold to groups**

Now consider a developer who acquires numerous acres of real estate for the development of a planned community. The developer sells parcels within the planned development to groups formed as LLCs (or TICs).

The parcels are advertised as being suitable for development as part of the planned community.

The developer does not promise to develop the parcels sold to the LLCs or to produce profits for the LLCs based on the development of the entire project, adjacent parcels, off-site infrastructure or any profit pooling arrangement.

One group of investors who acquired a parcel makes a demand on the developer and his broker for a return of their investment, claiming a security was created since they relied on the developer to complete the development of the planned community, which did not occur.

However, the group of investors had complete control over the parcel it acquired from the developer — nothing remained to be done after acquisition, except for the investors to wait for the market to deliver a profit or loss.

Thus, no securities risk was created, only an economic risk. The transaction was merely a sale of real estate to the LLC, to hold for a profit on resale or later development as the group saw fit. [**De Luz Ranchos Investment, Ltd.** v. **Coldwell Banker & Company** (9th Cir. 1979) 608 F2d 1297]

**Risk capital tests**

State and federal courts apply slightly different tests to determine whether a securities risk exists in an investment program. In California, courts apply what is called the *risk capital test* to determine whether the investors in a syndicated real estate transaction benefit from securities law protection.

The California risk capital test requires the investors' capital to simply be placed at risk in a value-adding activity, **whether or not a profit** is expected or intended. Compared to federal securities law, the California securities law is further-reaching and covers more investment conduct.

The federal risk capital test, on the other hand, revolves around the element of the expectation of a profit on the investment in a value-adding activity. For a security to exist under the federal **risk capital test**, the investors must be induced to join the program by, among other activities, a promise that they will profit from their capital investment.

**Personal use coupled with development**

Under the California risk capital rule, a syndicator's mere promise of future profits does not create a securities risk unless it is accompanied by the promise to perform an activity that creates value, such as development.

For example, a developer sells memberships in a yet-to-be-built country club to investors. Later, when the developer fails to complete construction of the country club, the investors make a demand on the developer for their investment to be returned. They claim the developer violated California securities law since the club memberships sold were unqualified and non-exempt securities in a construction project.

The developer claims the country club memberships are not controlled by California securities laws since the memberships merely provide for personal recreation and involve no expectation of a profit.

However, unlike federal securities law with its profit-driven test, an expectation of profit is not of concern to the California securities law. Here, the sale of memberships was coupled with a securities risk. The investors risked their capital on a "yet- to-be-built" project, relying on the developer to **complete the construction** of the country club after the members released their investment funds to acquire membership in the group's ownership of the property. [Silver Hills Country Club, *supra*]

**Promised returns without development**

To avoid creating a security under California's risk capital test, the selection of a specifically **identified parcel** of real estate for acquisition must exist before the release of invested funds.

Even then, the only business that may be conducted after acquiring the property is either the location of tenants and rental of the property or the ultimate resale of the unaltered property at a profit.

If, on closing a purchase escrow, the investor receives **full value** for his investment in the form of a fixed asset, such as a share ownership in an existing parcel of real estate and a guarantee of a minimum profit, no security is created. The investor's capital is no more at risk than if he had purchased the asset outright, with or without a promise of profits. [**Hamilton Jewelers** v. **Department of Corporations** (1974) 37 CA3d 330]

In another example, a syndicator completes his due diligence investigation on a property he located and decides it is suitable for syndication. A detailed investment circular is prepared. The circular states the real estate will not be further developed or improved, but simply owned and operated for what it is — a rental income property.

The investors solicited by the syndicator know they will receive an existing fixed asset for their money. The property will not be altered, further improved or converted to another use after acquisition. Thus, their capital is not subjected to a securities risk — only the **economic risks** of locating tenants and incurring expenses in the rental marketplace, activities experienced by all property owners.

All money invested in real estate is, to some extent, at risk of loss due to fluctuating property values brought about by economic conditions, natural hazards, etc., called marketplace risks. However, marketplace risks merely affect the level of income, profit or loss. Income and profits (or losses) from ongoing rental operations in the local economy are not the concern of securities laws.

**Exemptions when securities risks exist**

A large number of investments that contain a securities risk are **exempt** by statute from control under the securities law.

Investment programs offered by banks and savings and loans (S & Ls) are exempt from securities law, as are *non-public offerings* by individuals.

The non-public offering exemption is the most useful exemption available to syndicators who put together an investment program which includes an activity containing a securities risk.

The non-public offering exemption, called the 35-or-less interrelationship rule, applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire; and

- the solicitation of investors does not involve public advertising. [Calif. Corporations Code §25102(f)]

Thus, when an investment program does contain securities risks, such as exist in a construction or development project, the syndicator does not need to be further concerned with the securities law if his program meets the requirements of the 35-or-less interrelationship rule for the non-public offering of a security.

If a securities risk does not exist in the investment program, the solicitation of investors by public advertising is not an activity which places the investors' funds at risk.

**Disclosure of securities and limitations on recovery**

Consider a syndicator whose investment program contains a securities risk activity such as conversion or development. To solicit investors, he posts his offering in the recreational rooms of condominium projects and mobilehome parks he has an interest in. He does not obtain a permit nor does he register the sale of the investment program with the DOC or SEC.

Here, the syndicator publicly offered his investment opportunity containing a securities risk to anyone visiting the recreational rooms. Thus, his investment program was a **non-exempt** offering of a security. As a result, any investor in the program can recover the full amount of his investment from the syndicator, plus 10% interest from the date of investment, less any distributions the investor has received. [Corp C §25503]

However, the investor's recovery of his investment under California securities laws is subject to a time constraint, called a statute of limitations. The limitation places a time deadline beyond which an investor is barred from filing a claim for the recovery of money. An action to recover the investor's funds must be filed within the earlier of:

- two years after the date the investor funds the investment; or

- one year after the investor discovers the securities law violation. [Corp C §25507]

If the syndicator, as part of his investment memorandum, discloses securities permits have not been obtained, the investor will be aware of the potential violation from the beginning. Thus, the investor's recovery under the California securities law will be subject to the one-year statute of limitations for filing his complaint.

Until the **one-year limitations period** expires, the investor in an investment program that contains a securities risk and does not qualify for an exemption or was not qualified for investors by the DOC, may unilaterally withdraw his investment funds at any time (plus interest and less any distribution of earnings).

However, when the year period has expired following disclosure and the close of escrow, the syndicator is no longer liable for any claims to money for securities violations.

Realistically, if an investor is willing to contribute his funds to a real estate syndication in the first place, he is unlikely to withdraw and file an action within one year. Real estate investments are unlikely to be observed as having gone sour within one year.

Thus, even if the syndicator is certain his investment program contains no activities that are securities risks that place the investors' funds at risk of loss after acquisition of the property, a disclosure that no permit exists limits the syndicator's exposure to civil monetary liability by commencing the one year statute of limitations. [See **first tuesday** Form 372 §1.7]

# Property Management

# Chapter 16 — Other amounts due under three-day notices

*This chapter focuses on the inclusion of amounts of money due the landlord under a lease agreement other than "rent" in a three-day notice to pay or quit.*

***Chapter 16 Outline***

*Know what the judge, not the law, will allow*
*Lump sum late charges*
*Landlord's options for collection of fees/charges*
*Late charges to compensate for costs*
*Late charges as liquidated damages*
*Imposing the late charge*
*Too late to collect*
*The UD court sitting judge problem*

***Chapter 16 Terms***

*Delinquent*
*Due date*
*Grace period*
*Late payment fee*
*Masked late charges*
*Materially breaches*
*Penalty assessment*
*Three-day notice to pay or quit*
*Unlawful detainer (UD) action*

**Know what the judge, not the law, will allow**

A lease agreement between a landlord and his tenant contains a rent provision with a clause calling for the accrual of interest on any amount of rent from its due date if the payment becomes delinquent, a type of *late payment fee*.

The tenant fails to pay rent on the due date and before it becomes delinquent. The landlord then prepares a *three-day notice to pay or quit* and serves the notice on the tenant. [See **first tuesday** Form 575-1 accompanying this chapter]

The **three-day notice** itemizes the amounts of delinquent rent and daily interest accrued that are due and unpaid on the date the notice is prepared. The tenant fails to pay or quit during the three-day period. The landlord files an *unlawful detainer (UD) action* asking the court to order the removal of the tenant from the premises.

At the UD hearing, the tenant claims the landlord cannot terminate his possession of the premises under the three-day notice since the notice demands payment of an amount greater than the rent due under the lease agreement, and thus is defective as the demand includes other amounts due the landlord.

May the three-day notice include amounts due under monetary provisions in the lease agreement in addition to the "rent" itself?

Yes! **Monetary amounts due** under rent provisions in the rental or lease agreement that may be demanded in the three-day notice to pay or quit are not limited to the scheduled amount of periodic rent which is delinquent.

While the notice to pay may not be served until rent is delinquent, the notice itself is all-inclusive allowing it to state the total amount which is due, not only the delinquent amount entitled rent. Thus, the notice may include all sums of money which are due and unpaid under the rental or lease agreement at the time the notice is served, including the delinquent rent. [**Canal-Randolph Anaheim**, **Inc.** v. **Moore** (1978) 78 CA3d 477]

Examples of amounts of money due periodically under a rental or lease agreement, in addition to scheduled rent, include:

- common area maintenance charges (CAMs);
- association charges;
- pro rata insurance premiums, property taxes and bonded assessments;
- late payment fee and bad check charges;
- expenses incurred by the landlord to cure waste or failure to maintain the property, called **future advances**; and
- other amounts of money properly due as compensation or reimbursement of expenses arising out of the occupancy.

A three-day notice to pay or quit form provides for the itemization of rent and other amounts due which are unpaid and delinquent. [See **first tuesday** Form 575]

## Lump sum late charges

Under a nonresidential lease agreement entered into by a tenant, rent is typically due and payable on the first day of each month, called the *due date*. The lease agreement contains a late charge provision stating the tenant agrees to pay a charge in the amount of $150 if the rent is not received by the landlord on or before the fifth day of each month, called a *grace period.* [See **first tuesday** Form 552 §3.9]

Under the lease agreement, rent is *delinquent* the day after the grace period runs, the sixth day of the month. The delinquency triggers the landlord's right to demand payment of the late charge, or do nothing and waive it.

The lease agreement also provides for the tenant to pay $25 for each rent check returned for insufficient funds (NSF). [See **first tuesday** Form 552 §3.10]

During one month, the landlord receives the rent after the grace period expires. As he must, the landlord accepts the rent since the right to possession, the leasehold, has not been terminated by a declaration of forfeiture or expiration of the lease agreement. The landlord then notifies the tenant in writing that he is imposing a late charge, payable with the following month's rent, as provided in the lease agreement. [See **first tuesday** Form 569]

The following month the landlord receives the regularly scheduled rent within the grace period. However, the tenant does not also tender the late charge the landlord demanded due to the prior month's delinquent payment.

### Landlord's options for collection of fees/charges

On the tenant's failure to pay additional charges, the landlord's options to enforce payment, viable or not, include:

- returning the rent check to the tenant as insufficient payment for the total amount due;
- serving the tenant with a three-day notice to pay or quit;
- deducting the additional charge from the security deposit on written notice to the tenant; or
- filing an action against the tenant in small claims court to collect the late charge.

Returning the rent check to the tenant will result in one of the following scenarios:

- The tenant will submit another check which includes rent and payment of the late charge (which payment will be delinquent and arguably incur another late charge); or
- The tenant will retain the rent check as having been properly tendered and therefore legally paid, and do nothing more until he sends a check for the following month's rent.

A tenant who fails to pay the scheduled rent or otherwise *materially breaches* the lease agreement, may be served with the appropriate three-day notice. The three-day notice based on a material breach properly includes a demand for late charges and any other monetary amounts past due [Canal-Randolph Anaheim, Inc., *supra*]

If the tenant fails to cure the breach within three days following service of the notice and remains in possession, the landlord may file an **unlawful detainer** (UD) action to regain possession. [Calif. Code of Civil Procedure §1161]

However, a landlord will not succeed in a UD action when the landlord's refusal to accept the tenant's timely tender of a rent check is based solely on the tenant's refusal to pay late charges or other non-scheduled amount due. Failure to pay the agreed late charge after notice is a minor breach. [Canal-Randolph Anaheim, Inc., *supra*]

Thus, the landlord has two **viable options** for the collection of unpaid late (or bounced check) charges from the tenant:

- accept the rent check, deduct the amount of the unpaid late charge from the security deposit and advise the tenant of the deduction in writing; or
- accept the rent check and file an action in court for the unpaid late charge amounts.

The financially practical action the landlord can take when the tenant refuses to pay a demand for a late charge is to accept the rent and deduct the late charge from the tenant's security deposit.

A UD action cannot be maintained if the sole existing breach of the lease agreement is the failure to pay the late charges.

A **material breach** is required to support a UD action, such as a delinquency in the scheduled rent and other scheduled periodic compensation for occupancy and use of the property. A late charge is properly sought when pursuing delinquent rent, but alone, a late charge (or bounced check charge) is a minor breach and will not independently support a UD action. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

**Late charges to compensate for costs**

To be enforceable, late charges must be rea**sonably related** to:

- the actual costs of collecting the delinquent rent (the time and effort involved); and
- the delay in its receipt (loss of use, such as interest).

A lump sum late charge becomes an unenforceable *liquidated damages provision* if the amount of the late charge is significantly greater than the actual **out-of-pocket losses** suffered by the landlord due to the tenant's late payment of rent, in which case the charge is labeled a penalty and is unenforceable. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

*Editor's note — Some may argue any lump sum late charge on residential property is void as a liquidated damage since out-of-pocket money losses due to a late payment are readily ascertainable, especially in a residential real estate transaction.*

A **liquidated damages provision** in a residential lease is void, unless the loss covered is impracticable or nearly impossible to calculate (which it is not), or the amount agreed to is a reasonable estimate of the landlord's out-of-pocket expenses for the collection effort. [Calif. Civil Code §1671(d)]

When setting the amount of a late charge for a residential tenant's failure to timely pay rent under a rental or lease agreement, consider charging an amount equivalent to the late charge allowed by the legislature on a residential loan since the amount is a good indicator of reasonableness.

The late charge amount allowed for a delinquent payment on a loan secured by residential property is controlled by statute. This is not the case for rent, but should be.

For example, the lump sum late charge allowed on a loan secured by an owner-occupied, single-family residence cannot exceed 6% of the delinquent payment (principal and interest only). [CC §2954.4(a)]

Rent is the economic equivalent of interest. For purposes of late charges, rent payments should be treated no differently than interest payments.

**Late charges as liquidated damages**

A lump sum late charge set forth as a dollar amount in a lease agreement is a **liquidated damages provision**. The charge is a one-time, predetermined fixed amount intended by its nature to reimburse the landlord for the **delay in receipt** of the rent money and his **costs and effort** spent to collect the delinquent amount. [CC §1951.5]

A late charge provision calling for **interest to accrue** at a predetermined annual percentage rate on amounts earned and unpaid (delinquent rent) is not a liquidated damages provision and is fully enforceable. [Canal-Randolph Anaheim, Inc., *supra*]

However, some landlords wrongfully view late charges as a means for **coercing tenants to pay** rent on time, or structure them as a discount is paid timely so to take advantage of permissible local rent control adjustments during periods of weak rent market rates. Thus, landlords set the late charge at an amount exceeding his actual out-of-pocket money losses, a *penalty assessment* that is unenforceable.

A lump sum late charge provision in a nonresidential lease agreement is valid unless the tenant can show the amount of the late charge is an unreasonable reimbursement for the delay in receipt of the rent and costs of collection efforts. [CC §1671(b)]

A late charge is unenforceable if the charge is so great in comparison to actual losses that it **imposes a penalty** on the tenant for his late rent payment. [Garrett, *supra*]

An appropriate late charge provision in a lease agreement for single-user residential or nonresidential property encumbered by a loan is the amount of the late charge imposed on the owner when a monthly payment on the loan is delinquent.

The owner is simply "passing through" the loss incurred by his late receipt of the tenant's rent payment.

However, in a residential lease agreement, a late charge provision setting a fixed amount is void unless the losses suffered by the landlord due to late payment are impracticable to calculate. [CC §1671(d)]

*Editor's note — Determining money losses suffered due to late payments in any real estate transaction, especially in a residential lease, is not impracticable to calculate since it is merely an accounting of known amounts incurred as expenses in the collection and lost use of the funds until received.*

**Imposing the late charge**

A late charge called for in the provisions of a lease agreement is **not automatically due** and payable by the tenant when the landlord fails to receive the rent payment within the grace period.

The landlord must first make a **written demand** on the tenant for payment of the late charge and include the date when the charge is payable before the collection can be enforced.

Thus, a written billing demanding payment of the late charge with the next month's rent is delivered to the tenant to ensure the late charge agreed to is imposed. [See **first tuesday** Form 568]

The **late charge notice** advises the tenant the landlord is entitled to enforce collection of the unpaid late charge by:

- deducting the unpaid late charge amount from the tenant's security deposit; or
- filing a small claims or municipal court action for unpaid late charge amounts.

**Too late to collect**

Within one year from the date rent became delinquent, or some other **material breach** of a monetary provision in the lease or rental agreement occurred, the landlord must serve a three-day notice on the tenant to be able to enforce collection of the amounts sought in a UD action. [CCP §1161(2)]

As an alternative to seeking a recovery of money in a UD action with its one-year limitation, the landlord can file a separate money action within four years of the breach to collect unpaid late charges, returned check handling charges and any other amounts due under the lease agreement. [CCP §337]

Ultimately, the landlord can deduct the late charges from the tenant's security deposit as payment of unpaid amounts due the landlord under the lease agreement. [CC §§1950.5(b)(1); 1950.7(c)]

**The UD court sitting judge problem**

While the enforcement of lump sum late charges for the recovery of collection efforts has not been the subject of reported cases, the court in *Canal-Randolph Anaheim, Inc.* ruled an interest-rate late charge on delinquent rent to cover the loss of use of the payment can be included as amounts due under a rental or lease agreement.

# THREE-DAY NOTICE TO PAY RENT OR QUIT

Without Rent-Related Fees

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**NOTE:** A tenant who fails to pay the amounts due under a rental or lease agreement must, within three (3) days after service of written notice of the breach, either pay the amount due or vacate and deliver possession of the premises to the landlord. [Calif. Code of Civil Procedure §1161(2)]

**DATE:** ____________, 20______, at ______________________________, California.
**To Tenant:** ______________________________
*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** You are a Tenant under a rental or lease agreement
- 1.1 dated ______________, at ______________________________, California,
- 1.2 entered into by ______________________________, as the Tenant, and
- 1.3 ______________________________, as the Landlord,
- 1.4 regarding real estate referred to as ______________________________
______________________________.

**NOTICE:**

**2.** You are in breach of the payment of amounts due under the rental or lease agreement.

**3.** Within three (3) days after service of this notice you are required to either
- 3.1 Pay rent and other amounts now due and unpaid in the **Total Amount** of . . . . . . . . . . . . . $0.00
representing rent for the periods of
____________, 20______ to ____________, 20______ . . . . . Amount $______________
____________, 20______ to ____________, 20______ . . . . . Amount $______________
____________, 20______ to ____________, 20______ . . . . . Amount $______________
**and** amounts due for
☐ common area maintenance (CAM) of . . . . . . . . . . . . . . . . . . . . . . $______________
☐ association assessments of . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $______________
☐ property taxes of. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $______________
The **Total Amount** due may be paid in one of the following manners:
a. By personal delivery to ______________________________ (Name)
______________________________ (Address)
______________________________
Payment of the Total Amount due will be accepted at the above address during the hours of ______ to ______ on the following days: ______________________________.
b. By deposit into account number ______________________
at ______________________________ (Financial Institution)
______________________________ (Address)
______________________________
c. By the electronic funds transfer previously established between Landlord and Tenant.
d. ______________________________.

**OR**

- 3.2 Deliver possession of the premises to Landlord or ______________________________
______________________________.

**4.** If you fail to pay the Total Amount due, or to deliver possession of the premises within three (3) days, legal proceedings will be initiated against you to regain possession of the premises and to recover the amounts owed, treble damages, costs and attorney fees.

**5.** The Landlord hereby elects to declare a forfeiture of your Right to Possession if you fail to pay the Total Amount demanded above.
- 5.1 Landlord reserves the right to pursue collection of any future loss of rent allowed by Civil Code §1951.2.

Date: ____________, 20______
Landlord/Agent: ______________________ DRE #: ____________

Signature: ______________________________
Address: ______________________________
Phone: ______________________ Cell: ______________________

**FORM 575-1** 03-11 

*Canal-Randolph Anaheim, Inc.* clarified that a landlord may include any sums due under the lease as **amounts due** in the three-day notice.

Also, no statutes exist that forbid (or limit) the collection of a late charge in a rental or lease agreement. However, cases do limit the charge to an amount reasonably calculated to cover the losses inflicted by late payment. [Garrett, *supra*]

Further, not all trial judges will concede late charges are part of the **amount due** under a three-day notice. Despite the holding of Canal-Randolph Anaheim, Inc., some judges declare late charges are not rent, the delinquency of which triggers use of a three-day notice to pay or quit. [CCP §1161(2)]

These judges hold a late charge or bad check charge cannot be included in the three-day notice as part of the amount due under the lease agreement. If included, the demand would bar an eviction before those judges.

Before a landlord or a property manager includes any late charge (or other **amounts due** besides technical rent) in a three-day notice as part of the total amount due, it should first be determined if the judge presiding over UD actions in the landlord or property manager's jurisdiction will allow a demand for agreed to and reasonable late charges.

Judges vary in their approach to late charges:

- some allow *masked late charges* (used in rent control communties) cloaked as a forgiveness of 6% to 10% of the scheduled rent, if paid before the rent (including the masked late charge) is considered due or with a grace period delinquent — within five to 10 days after it is due;

- some allow a late charge of up to 6% of the delinquent rent as a reasonable amount;

- some disallow late charges as an unenforceable penalty for being delinquent;

- some disallow late charges as a forfeiture of money (since the amount exceeds the costs of collection); and

- some just disallow late charges altogether as an exercise of their discretion.

Information on the treatment given by the local trial court judge can be obtained from an attorney or other landlords who have experience appearing in front of the judge in question.

If the judge will not allow the late charge as part of the amount due from the tenant, the landlord should leave it out of the three-day notice. Instead, either deduct the late charge from the security deposit (if any remains when refunded), or pursue collection in a separate action for money, both of which avoid the issue of demands placed in the three-day notice as a requisite to a UD action.

Investigate the judge's behavior first to eliminate the risk of getting an erroneous judicial determination that late charges or other amounts due were improperly included in the three-day notice and therefore a denial of the eviction requiring an appeal or renewal of the three-day notice and UD process without the late charge.

*Editor's note — An obvious solution to the inconsistent rules applied to late charges would be* ***public policy*** *legislation defining the nature of late charges and acceptable limits on time and amounts for recovery of the cost of collecting delinquent rent — guidance for all involved in the UD process.*

*Late charges for rent should be treated like late charges on mortgages. Both serve the same economic function — recovery of costs incurred due to the delay of receipt of funds and resulting collection efforts. Also, the number of homeowners with mortgage payments is almost equal to the number of renters with rental payments in California. Both mortgage payments and rental payments are part of the cost of occupancy and entitled to equivalent legislative controls.*

# Chapter 17 — Security deposits and pre-termination inspections

*This chapter examines the variety of security deposit rules controlling residential and nonresidential landlords who receive these funds, and the residential tenant's right to a pre-termination inspection to preserve these funds*



### *Chapter 17 Terms*

| | |
|---|---|
| *Impounds* | *Notice of entry* |
| *Initial inspection* | *Pet deposit* |
| *Joint pre-termination inspection* | *Security deposit* |

**Residential and nonresidential rules**

An investor in nonresidential, income-producing properties has located residential rental property priced by the seller at a respectable capitalization rate. The residential rental property is a larger apartment complex consisting of both furnished and unfurnished units.

The investor retains a broker with experience managing apartment buildings of comparable size and quality in the local rental market. The investor has never owned or operated residential rentals and needs advice, which he is willing to pay for.

The broker makes an initial inspection of the units and discusses the project with the resident manager. The impact of the local residential rental market on rents and security deposits in this property are reviewed with the investor.

As a result, rents and security deposits to be charged will be re-set based on the size of the units, the maximum number of occupants for the various sizes of units, amenities each unit offers, each unit's location within the complex and whether or not the units are furnished.

The investor is aware he must rent to families with children whose credit and background qualify them as tenants. However, the investor is concerned about the excessive wear and tear children could cause to the units. The investor is advised any excessive wear and tear brought on by a tenant which remains unrepaired when the tenant vacates is a breach of the lease, called a default. Any clean-up expenses incurred by the landlord are recoverable from the tenant, the security deposit being the primary source of recovery.

If a unit will be occupied by a family with children whose family size or background check indicates they will likely place an excessive burden on the unit, the broker can recommend either:

- the unit not be rented to them as inadequate space for the family; or
- the rent be adjusted upward to cover the additional wear and tear brought about by the burdensome increase in the number of occupants above the standards set for units of comparable size.

However, the decisions about the treatment of families made by the investor and his broker must be consistent with their treatment of all tenants, such as number of occupants and the adequacy of the space to accommodate them.

The investor would like to impose a larger *security deposit* equal to one-half month's rent for each child who will occupy a unit since the increased deposit would either discourage large families from renting or provide funds to restore the unit for re-renting when they vacate.

The property manager informs the investor that security deposits charged to tenants of residential units who fall into a protected class of people, such as families, are controlled by statute and call for nondiscriminatory, equal treatment without regard to family size.

Thus, the investor is cautioned he cannot require higher security deposits for tenants with children than for tenants without children, equal creditworthiness considered. Any increase in a **security deposit** for larger versus smaller families is a prohibited discriminatory practice. There must be a rational basis other than the fact that they are a family and children are involved. [Calif. Government Code §12955(a); 24 Code of Federal Regulations §100.65]

Other limitations are placed on the tenant's upfront advance for rent and security deposits. In addition to the collection of **one month's advance rent**, the further amount a residential tenant may be required to pay as a security deposit to cover defaults is limited to an amount equal to:

- two months' rent for unfurnished units; and
- three months' rent for furnished units. [Calif. Civil Code §1950.5(c)]

If competition in the local rental market permits, the investor may require an advance payment from all tenants in an unfurnished unit of no more than:

- the first month's rent and a security deposit equal to two months' rent; or

- the first month's rent and the last month's rent and a security deposit equal to one month's rent.

The property manager informs the investor a security deposit equal to one month's rent, together with one month's advance rent, is all the market will currently bear to keep the units occupied. If he demands more, the units will not readily rent since prospective tenants will likely be unwilling to pay that amount up front under current market conditions.

**Security to cover nonperformance**

Both nonresidential and residential landlords traditionally require tenants to deposit funds with the landlord as security, in addition to the first month's rent. [See **first tuesday** Form 550 §2.1 and **first tuesday** Form 552 §1.2]

The additional funds provide **security** against the tenant's default on obligations agreed to in the rental or lease agreement. Tenant obligations include paying rent, reimbursing the landlord for expenses incurred due to the tenant's conduct, maintaining the premises during occupancy and returning the premises in the same level of cleanliness as existed at the time possession was initially taken, less ordinary wear and tear.

For **residential rentals**, all monies paid to the landlord in addition to the first month's rent are considered part of the security deposit, except screening fees and waterbed administrative fees. *Security deposits* include any funds received for the purpose of covering defaults by the tenant under the rental or lease agreement, regardless of the name given to the funds by the landlord, such as a nonrefundable deposit, cleaning charge or last month's rent. [CC §§1940.5; 1950.5(b), (c); 1950.6]

Thus, any funds legally recharacterized as a security deposit are **refundable** when the tenant vacates, less deductions for unpaid rent and recoverable costs incurred by the landlord for the repair of damages caused by the tenant.

For nonresidential tenancies, security deposit amounts may vary based on the tenant's type of operations and the accompanying risks of damage they pose to the leased property. For instance, a small services firm may pay an amount equal to one month's rent as a security deposit, while a photography studio which uses chemicals in its film processing may be asked to pay an amount equal to two month's rent.

*Editor's note — A photography studio tenant or other users of chemicals must also be required to provide insurance coverage.*

Like all other terms in a nonresidential lease, the amount of the security deposit is negotiable between the nonresidential landlord and the tenant prior to entering into the lease.

In a market downturn, aggressively competitive landlords are less likely to require a security deposit in exchange for maintaining current rental income (occupancy), which exposes them to an increased risk of loss if the tenant defaults.

Unlike nonresidential tenants, residential tenants, as a matter of public policy, are perceived as lacking bargaining power when they negotiate a rental or lease agreement. Thus, limits are imposed by law on the amount of security deposit a residential landlord may require.

**The problematic last month's rent**

On residential rentals, a payment of the first and last month's rent is recharacterized to become advance rent for the first month of the occupancy with the balance being a security deposit which was called the last month's rent, plus any other amounts eligible to be classified as a security deposit. [CC §1950.5(c)]

Nonresidential landlords also typically require an advance payment of both the first and last month's rent on a lease, but then it depends on the financial strength and the term of the lease as to whether any deposit is required at all beyond the advance of the first month's rent. Market conditions of availability and creditworthiness are the controlling factors.

Now consider a residential tenant who pays the first month's rent and a security deposit equal to one month's rent on entering into his rental or lease agreement.

When the last month's rent becomes due, the tenant does not pay it. The tenant knows the defaulted payment of rent will be deducted from his security deposit; a permissible use of the security deposit by the landlord.

On expiration of the lease, the tenant vacates the unit. Due to excess wear and tear on the unit inflicted by the tenant, repairs and replacements are required before the unit can be re-rented.

However, after deducting the unpaid last month's rent from the security deposit, no money remains to reimburse the landlord for the cost of the repairs.

The recovery of the repair costs is limited to a demand on the tenant for payment. If unpaid, a small claims court action may be used to enforce collection.

A similar demand must be made on the tenant for payment of repair costs when the landlord requires advance payment of the first and last month's rent, but no security deposit.

**Residential deposits: not rent, not fees**

A residential landlord must require the same security deposit for all units, such as an amount equal to one month's rent, or base the amount of the security deposit on each tenant's creditworthiness.

*Editor's note — If a landlord sets the amount of the security deposit based on a tenant's creditworthiness — the greater or lesser risk of a loss due to a prospective tenant's likely failure to perform on lease provisions — he must establish clear and precise standards for his different levels of creditworthiness (such as credit scoring or percentage on income paid for rent) and apply each level's standard equally to all prospective tenants who meet that level of credit or ability to pay. Lenders set levels of creditworthiness and charge different rates of interest for each level. [24 CFR §100.60(b)(4)]*

Any money handed to a residential landlord by a tenant on entering into a rental or lease agreement must be **characterized** as one of the following:

- a tenant screening fee for processing an application;
- a waterbed administrative fee;
- rent; or
- a security deposit. [CC §§1940.5(g); 1950.5(b); 1950.6(b)]

A residential landlord has authority to require an additional **pet deposit** if the tenant is permitted to keep one or more pets in the unit, but the authority is limited.

The total amount of advance funds received from a tenant with a pet may not exceed three month's rent for an unfurnished unit or four month's rent for a furnished unit. [CC §1950.5(c)]

However, a disabled tenant accompanied by a tagged guide, signal or service dog cannot be required by the landlord to pay any extra rent, charge or security deposit for the dog to be kept on the premises.

Disabled persons accompanied by a specially trained dog must keep the dog leashed and tagged as a specially trained dog by an identification tag issued by the county clerk, animal control department or some other authorized agency.

The owner of a guide, signal or service dog will be held liable for the cost to repair any damages brought about by the dog's activities. [CC §54.2(a)]

Just as a landlord may increase the deposit amount for tenants who have a pet, a tenant who wishes to maintain a **waterbed on the premises** may also be subject to an increased security deposit amount.

The residential landlord of an unfurnished unit may require, in addition to the first months' rent:

- an amount equal to **one-half month's rent**, in addition to the maximum security deposit; and
- a **reasonable fee** to cover administrative costs of processing the waterbed arrangements. [CC §1940.5(g)]

Also, if the term of a residential lease is six months or more, the landlord and tenant may then agree to an advance payment of six months' rent, or more, instead of one month's rent. [CC §1950.5(c)]

Thus, advance payment of an amount equal to only two to five months' rent is prohibited.

# NOTICE OF RIGHT TO REQUEST A JOINT PRE-EXPIRATION INSPECTION

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**NOTE:** Residential tenants may request a joint pre-expiration inspection of the premises they occupy. At the inspection they will receive a statement of deficiencies itemizing the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit. [Calif. Civil Code §1950.5(f)]

**DATE:** ____________, 20_____, at ______________________________________________, California.
**To Tenant:** ______________________________________________________________________
*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** You are a Tenant under a rental or lease agreement
   1.1 dated ________________, at ______________________________________________, California,
   1.2 entered into by ______________________________________________, as the Tenant, and
   1.3 ______________________________________________________________, as the Landlord,
   1.4 regarding real estate referred to as ______________________________________________,
   1.5 which tenancy expires ____________, 20_____.

**NOTICE:**

**2.** You are hereby advised of your right to request and be present at a pre-expiration inspection of the premises you occupy, and at the time of the inspection, be given Landlord's itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deduction from your security deposit.
   2.1 The purpose for the inspection and the statement of deficiencies is to give you the opportunity to remedy or eliminate the itemized deficiencies before vacating to avoid a deduction of their cost from your security deposit.
   2.2 The inspection, if requested by you, may be scheduled no earlier than two weeks before the expiration of your tenancy, and is separate from Landlord's final inspection and accounting for your security deposit within 21 days after you vacate.
   2.3 If you do not request a pre-expiration inspection, no inspection will be made prior to the final inspection after you vacate.

**3.** You may request an inspection at any time after you are given this notice by preparing the form attached to this notice and giving it to Landlord or his agent.
   3.1 On Landlord's receipt of your request, Landlord will attempt to set a mutually agreeable date and time for the inspection.
   3.2 On Landlord's receipt of your request, you will be given a written 48-hour notice of entry advising you of the date and time scheduled by Landlord for the inspection.

**4.** On completion of the scheduled inspection, whether or not you are present, Landlord or his agent will hand you or leave on the premises a copy of an itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deductions from your security deposit, unless you remedy or eliminate them prior to your vacating on or before your tenancy expires.
   4.1 Once you have requested an inspection you may withdraw the request at any time prior to the inspection.

Date: ____________, 20_____
Landlord/Agent: ________________________ DRE #: __________

Signature: ______________________________________________
Address: ______________________________________________
______________________________________________
Phone: ________________________ Cell: ________________
Fax: ______________________________________________
Email: ______________________________________________

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PAGE TWO OF TWO — FORM 567-1

**REQUEST FOR JOINT PRE-EXPIRATION INSPECTION**

**Prepared by: Agent** ______________________ **Phone** ______________________
**Broker** ______________________ **Email** ______________________

**DATE**:____________, 20_____, at ________________________________________, California.

**To Landlord:**

**1.** I, the Tenant, hereby request an inspection at the earliest possible date and time during the two-week period prior to the expiration or termination of my tenancy.

**2.** The dates I prefer for an inspection during normal business hours include ______________________________
__________________________________________________________________________

**3.** I understand you will give me a 48-hour notice prior to the inspection.

Address of the premises ______________________________________________________

Tenant's name ______________________________________________________

Signature ______________________________________________________

Daytime telephone number ____________________

**FORM 567-1** 03-11 ©2011 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Should the landlord and tenant agree to an advance payment of six months' rent on the lease of an unfurnished unit, the landlord may also require the maximum security deposit of two months' rent.

## Landlord treatment of security deposits

Security deposits are held by the landlord as *impounds*. The funds belong to the tenant who advanced them and must be accounted for. [CC §§1950.5(d); 1950.7(b)]

However, while the security deposit belongs to the tenant, a landlord may **commingle** the funds with other monies in a general business account. No trust relationship is established when a landlord holds a tenant's security deposit. [**Korens** v. **R.W. Zukin Corporation** (1989) 212 CA3d 1054]

Without a trust relationship, the landlord's receipt of a security deposit does not obligate him to pay **interest** on the security deposit for the period held. However, some local rent control ordinances require residential landlords to pay interest to tenants on their security deposits.

For example, the city of San Francisco requires residential landlords to pay simple interest to tenants on security deposits held by the landlord for one year or more as long as the rent is not subsidized by any government agency. [San Francisco Administrative Code §49.2]

## Joint pre-termination inspection

A residential landlord must **notify a tenant** in writing of the tenant's **right to request** a joint inspection of his unit to be held during the two weeks prior to the date for expiration of:

# STATEMENT OF DEFICIENCIES ON JOINT PRE-EXPIRATION INSPECTION

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**DATE:** ____________, 20_____, at ______________________________________________, California.

**To Tenant:** ________________________________________________________________

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** On this date, a pre-expiration inspection was conducted by Landlord on the premises and appurtenances which are the subject of a rental or lease agreement

1.1 dated ________________, at ______________________________________________, California,

1.2 entered into by__________________________________________________, as the Tenant(s), and ____________________________________________________________, as the Landlord,

1.3 regarding real estate referred to as ______________________________________________ ______________________________________________________________________.

1.4 ☐ Tenant was present and given a copy of this statement prepared and signed by Landlord or his agent.

1.5 ☐ Tenant was not present and a copy of this statement prepared and signed by Landlord or his agent was left inside the premises.

**2.** The tenancy under the rental or lease agreement expires on ____________, 20_____, by which date you are to vacate the premises.

**3. NOTICE TO TENANT:**

3.1 You have until the date for expiration of your tenancy to remedy or eliminate the repairs and cleaning specified in this Statement of Deficiencies to avoid the deduction from your security deposit of the cost to repair and clean the identified deficiencies.

3.2 Unobservable conditions or conditions which occur after the pre-expiration inspection requiring repair and cleaning will be deducted from your security deposit after the final inspection by Landlord or his agent.

**STATEMENT OF DEFICIENCIES:**

**4.** The following itemized list of identified deficiencies in repairs and cleaning will be the basis for deductions from your security deposit, unless remedied or eliminated by you prior to vacating and later confirmed by Landlord or his agent during a final inspection after you vacate.

4.1 Damage to the premises and appurtenances caused by Tenant or their guests, other than ordinary wear and tear, which needs to be repaired are listed as follows: ____________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________.

4.2 Cleaning which needs to be performed to bring the premises up to the level of cleanliness which existed on commencement of the tenancy is listed as follows: ____________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________
______________________________________________________________________.

**5.** The following recitals are excerpts from Civil Code §1950.5 regarding security deposits:

5.1 1950.5(b) As used in this section, "security" means any payment, fee, deposit or charge, including, but not limited to, any payment, fee, deposit, or charge, except as provided in Section 1950.6, that is imposed at the beginning of the tenancy to be used to reimburse the landlord for costs associated with processing a new tenant or that is imposed as an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:

(1) The compensation of a landlord for a tenant's default in the payment of rent.

(2) The repair of damages of the premises, exclusive of ordinary wear and tear, caused by the tenant or by a guest or licensee of the tenant.

(3) The cleaning of the premises upon termination of the tenancy necessary to return the unit to the same level of cleanliness it was in at the inception of the tenancy. The amendments to this paragraph enacted by the act adding this sentence shall apply only to tenancies for which the tenant's right to occupy begins after January 1, 2003.

(4) To remedy future defaults by the tenant in any obligation under the rental agreement to restore, replace, or return personal property or appurtenances, exclusive of ordinary wear and tear, if the security deposit is authorized to be applied thereto by the rental agreement.

5.2 1950.5(d) Any security shall be held by the landlord for the tenant who is party to the lease or agreement. The claim of a tenant to the security shall be prior to the claim of any creditor of the landlord.

Date: _____________, 20______

Landlord/Agent: _____________________________ DRE #: __________

Signature: ______________________________________________________

Address: _______________________________________________________

_______________________________________________________________

Phone: __________________________ Cell: ______________________

Email: _________________________________________________________



- the lease term; or
- a 30-day notice to vacate initiated by either the landlord or the tenant. [CC §1950.5(f)(1); see Form 567-1 accompanying this chapter]

The requirement of notice does not apply to tenants who are unlawfully remaining in possession after the expiration of a 3-day notice to pay/perform or quit for failing to pay rent, failing to perform terms and conditions of the rental agreement or committing waste or a nuisance on the property.

The purpose for the *joint pre-termination inspection*, legally called an *initial inspection*, is to require residential landlords to advise tenants of the repairs or conditions the tenant needs to perform or maintain to **avoid deductions** from the security deposit.

If a residential tenant requests the pre-termination inspection in response to the notice of his right to the inspection, the landlord or his agent must complete the inspection no earlier than two weeks before the tenant is to vacate the unit.

Ideally, the notice advising the tenant of his right to a joint pre-termination inspection is given to the tenant at least 30 days prior to the end of the lease term or, in the case of a rental agreement, immediately upon receiving or serving a 30-day notice to vacate.

A period of 30 days will allow the tenant time to request the inspection and provide two full weeks to prepare for the inspection. The tenant will have two weeks to remedy any repairs or uncleanliness the landlord observes during the inspection which might constitute a deduction from the security deposit.

On the landlord's receipt of the tenant's request for a pre-termination inspection, the landlord must serve a written 48-hour **notice of entry** on the tenant stating:

- the purpose of entry; and
- date and time of the pre-termination inspection.

If the date and time cannot be mutually agreed to, they are to be set by the landlord. However, if a mutually acceptable time for the inspection is within 48 hours, a written waiver of the notice of entry must be signed by both the landlord and tenant. [CC §1950.5(f)(1); see **first tuesday** Form 567-2]

When the waiver is signed, the landlord may proceed with the inspection, whether or not the tenant is present at the premises, unless the tenant has previously withdrawn his request for the inspection.

On completion of the pre-termination inspection, the landlord must give the tenant an itemized statement of deficiencies specifying any repairs or cleaning necessary to be completed by the tenant to avoid deductions from his security deposit.

Also, the itemized statement of deficiencies must contain the contents of subdivisions (b) and (d) of Calif. Civil Code §1950.5. [See Form 567-3 accompanying this chapter]

The landlord's pre-termination inspection statement must be delivered to the tenant by either:

- handing the statement directly to the tenant if he is present at the inspection; or
- leaving the statement inside the premises at the time of the inspection if the tenant is not present. [CC §1950.5(f)(2)]

The purpose for the inspection and statement of deficiencies in repairs or cleanliness is to give the tenant time in which to remedy the identified repairs before vacating the premises.

Alternatively, unless requested by the tenant, the landlord or his agent are not required to conduct an inspection or prepare and give the tenant a statement of deficiencies before the tenancy expires and the tenant vacates. However, the notice of the tenant's right to request a pre-termination inspection **must** be given to the tenant.

## CONFIRMATION MEMORANDUM

**Prepared by: Agent** ______________________ **Phone** ______________________
**Broker** ______________________ **Email** ______________________

**DATE**: ____________, 20_____, at ________________________________________, California.

| TO: ______________________ | FROM: ______________________ |
|---|---|
| Company ______________________ | Company ______________________ |
| Address ______________________ | Address ______________________ |
| ______________________ | ______________________ |
| Phone ____________ Fax ____________ | Phone ____________ Fax ____________ |
| Email ______________________ | Email ______________________ |

**FACTS:**

**1.** This memorandum confirms our conversation regarding the following contract:

☐ Listing/retainer agreement ☐ Rental/lease agreement
☐ Purchase agreement ☐ Trust deed loan number ____________________
☐ Escrow number ____________________ ☐ ______________________________

dated ____________, 20_____, at ________________________________________, California,
entered into by ________________________________________, as the ______________, and
________________________________________, as the ______________,
regarding real estate referred to as ________________________________________
________________________________________________________________.

**MEMORANDUM:**

**2.** On ____________________, 20_____, at approximately ________________ ☐ a.m., ☐ p.m.,
you and I personally spoke ☐ by phone, or ☐ in person at (*place*) ______________________________.

**3.** We agreed to the following: ________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________.

**4.** Your cooperation and commitment are appreciated and will be relied upon.

**5.** If this memorandum does not accurately state your understanding of our conversation, please contact me immediately to correct or clarify this memorandum.

**Signed and mailed this date.**

Broker: ________________________________________

By (print): ________________________________________

Signature: ________________________________________

**FORM 525** 03-11 

If the tenant chooses to withdraw his request for an inspection after submitting it, the landlord should send a memo to the tenant confirming the tenant's decision to withdraw. [See Form 525 accompanying this chapter]

*Editor's note — The completion of a pre-termination inspection statement by the landlord does not bar the landlord from deducting other costs from the security deposit for:*

- *any damages noted in the joint pre-termination inspection statement which are not cured;*

- *any damages which occurred between the pre-termination inspection and termination of the tenancy; or*

- *any damages not identified during the pre-termination inspection due to the tenant's possessions being in the way. [CC §1950.5(f)]*

Regardless of whether the tenant requests a pre-termination inspection, the final inspection and the itemized statement for the refund of the security deposit (less any deductions) must still be completed and mailed within 21 days after the **tenant vacates** the residential unit. [CC §1950.5(g)]

**Residential deposit refund requirements**

Within a window period of **21 days** after a residential tenant vacates, the residential landlord must:

- refund the security deposit, less reasonable deductions; and

- provide the tenant with an **itemized statement of deductions** taken from the security deposit. [CC §1950.5(g); see Form 585 accompanying this chapter]

Also, the residential landlord must **attach copies** of receipts, invoices and/or bills to the itemized statement showing charges incurred by the landlord and deducted from the security deposit. [CC §1950.5(g)(2)]

If repairs by the landlord are not completed and the costs are unknown within 21 days after the tenant vacates, the landlord may deduct a **good faith estimated amount** of the cost of repairs from the tenant's security deposit. This estimate is stated on the itemized security deposit refund statement, disclosing the name, address and telephone number of any person or entity providing repair work, materials or supplies for the incomplete repairs. [CC §1950.5(g)(3)]

Within 14 days after the **completion of repairs** or the receipt of bills, invoices and/or receipts for the repairs and materials, the landlord must deliver the final itemized security deposit refund statement with attached receipts and invoices to the tenant. [CC §1954(g)(3)]

It is not necessary for the residential landlord to provide copies of receipts, bills and/or invoices for repair work or cleaning to the tenant if:

## SECURITY DEPOSIT DISPOSITION ON VACATING RESIDENTIAL PREMISES

**Prepared by: Agent** ______________________________ **Phone** ______________________
**Broker** ______________________________ **Email** ______________________

**NOTE:** This itemized statement of the security deposit's disposition, including documentation of charges deducted, must be given to the Tenants by the Landlord within 21 days after a Tenant vacates residential property. [California Civil Code §1950.5(f)]

Use of this form in a timely and proper fashion avoids Landlord liability for a 2% monthly penalty on any portion of the security deposit wrongfully retained.

**DATE:** ____________, 20_____, at ______________________________________________, California.
**To Tenant:** ______________________________________________________________________

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This is notice to Tenant of any Landlord deductions from the security deposit under the following agreement:

☐ Residential lease agreement ☐ Occupancy agreement
☐ Residential rental agreement ☐ ________________________________

1.1 dated ____________, 20_____, at ________________________________________, California,
1.2 entered into by ____________________________________________________, as the Landlord, and
1.3 ______________________________________________________________________, as the Tenant,
1.4 regarding residential premises referred to as ___________________________________________.

**DISPOSITION OF DEPOSIT:**

**2.** Under the above referenced agreement, Tenant handed Landlord a security deposit in the amount of . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $______________

**3.** The following deductions have been made by Landlord from the security deposit:

3.1 Repair of damages — Cost
a. ____________________________________________ $______________
b. ____________________________________________ $______________

3.2 Necessary cleaning of the premises — Cost
a. ____________________________________________ $______________
b. ____________________________________________ $______________

3.3 Delinquent or holdover rent — Amount
a. From __________________ To ____________________ $______________

3.4 Replacement/repair of lost or damaged furnishings — Cost
a. ____________________________________________ $______________

3.5 **TOTAL** deductions from security deposit (line 3.1 to line 3.4) . . . . . . . . . . . . . . . . . . . . . (-)$______________

**4. BALANCE DUE TENANT:**

4.1 Balance of security deposit remaining after deductions (line 2 less line 3.5) . . . . . . . . . . . . $0.00
4.2 Interest on the security deposit from _______________ to _______________
at _____% per annum . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . (+)$______________
4.3 Balance due Tenant is refunded in the amount of (line 4.1 plus line 4.2) . . . . . . . . . . . . . . $0.00
by Landlord/Agent's check #____________.

**5.** ☐ **AMOUNT DUE LANDLORD:**

5.1 The amount due Landlord after deductions (line 2 less line 3.5). . . . . . . . . . . . . . . . . . . . . $______________
5.2 Less interest on the security deposit from _______________ to _______________
at _____% per annum . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . (-)$______________
5.3 Tenant to hand or mail Landlord/Agent the balance due of (line 5.1 less line 5.2) . . . . . . . . $______________

**This statement is true and correct.**

Date: ____________, 20_____
Landlord/Agent: ________________________ DRE #: __________

Signature: ________________________________________
Address: ________________________________________
________________________________________
Phone: ________________________ Cell: ________________
Email: ________________________________________

FORM 585 03-11 

- the total deduction from the security deposit to cover the costs of repairs and cleaning does not exceed $125; or

- the tenant signs a waiver of his right to receive bills at the time or after notice to terminate his tenancy is given. [CC §1950.5(g)(4)]

A residential tenant may request copies of receipts, bills or invoices for repair work or cleaning within 14 days after receipt of the itemized security deposit refund statement. The landlord is to provide copies of the documents within 14 days after receipt of the tenant's request. [CC §1950.5(g)(5)]

**Reasonable deductions** from a residential tenant's security deposit include:

- **delinquent rent**;

- **costs to clean** the premises after the tenant vacates — if the tenant agreed to and failed to leave the unit in the same level of cleanliness as existed when he took occupancy;

- **costs of repairs** for damages caused by the tenant, excluding ordinary wear and tear; and

- **costs to replace or restore** furnishings provided by the landlord if agreed to in the lease. [CC §1950.5(b)]

Unpaid late charges and bounced check charges incurred and requested on a proper demand may be deducted from the security deposit since they are a **form of rent** in that they are **amounts due** the landlord under the lease agreement.

The landlord may not deduct from a tenant's security deposit the costs he incurs to repair defects in the premises which existed prior to the tenant's occupancy. [CC §1950.5(e)]

Tenants seeking to recover security deposits retained by landlords may make unfounded claims that the excessive wear and tear existed when they took possession of the property. To best avoid claims of pre-existing defects, a joint inspection of the unit (landlord and tenant) and written documentation of any defects is completed **before possession** is given to the tenant. [See **first tuesday** Form 560]

**Security deposit refund statements**

When a residential tenant vacates, the landlord itemizes the deductions from the tenant's security deposit on a security deposit disposition statement. [See Form 585]

If a landlord is required by local rent control ordinances (or state law) to **pay interest** on security deposits, the landlord may also use the itemized statement to account for interest accrued on the security deposit. [See Form 585 §4.2]

A residential landlord who, in bad faith, fails to comply with security deposit refund requirements may be subject to statutory penalties of up to twice the amount of the security deposit. [CC §1950.5(l)]

A residential or nonresidential landlord also delivers an itemized statement to tenants on the **sale of the property**, indicating the amount of the security deposits, any deductions and the name, address and telephone number of the buyer. The notice, important for the seller, **shifts liability** for the future return of the security deposit to the buyer. [CC §§1950.5(h); 1950.7(d); see **first tuesday** Form 586]

**Nonresidential deposit refund rules**

A nonresidential lease does not need to set forth:

- the circumstance under which a tenant's security deposit will be refunded; or
- a time period within which a landlord will refund a tenant's security deposit.

Other than its receipt, a nonresidential lease does not even need to contain a provision addressing when the security deposit will be returned. [See **first tuesday** Form 552]

A nonresidential landlord must return the remainder of the security deposit within 30 days if:

- a refund period is not agreed to; and
- the nonresidential landlord takes no deductions from the security deposit.

Thirty days is considered a reasonable refund period since the landlord is allotted **30 days** to determine whether repairs are needed. Permissible deductions from the security deposit include unpaid rent, cost of cleaning or repairs. However, if the security deposit **exceeds** two months rent and the only deduction from the deposit is for delinquent rent, the nonresidential landlord must return any remaining amount in excess of one month's rent within two weeks after taking possession of the property. The remaining security deposit amounts must be returned to the tenant or accounted for within 30 days after the landlord takes possession. [CC §1950.7(c)]

Unless otherwise stated in the lease or rental agreement, the nonresidential landlord is prohibited from deducting additional costs from the security deposit for "key money" or to cover his attorney's fees incurred in preparing, altering or renewing the lease or rental agreement. [CC §1950.8(b)]

Unlike the residential landlord, the nonresidential landlord is not required to provide tenants with an itemized statement of deductions when the security deposit is refunded. However, a prudent nonresidential landlord provides tenants with an itemized statement when they vacate, unless a full refund is made.

An accounting avoids the inevitable demand for documentation which arises when a tenant does not receive a full refund of his security deposit. A nonresidential landlord who, in **bad faith**, fails to comply with the refund requirements is liable to the tenant for up to $200 in statutory damages. [CC §1950.7(f)]

# Chapter 18 — Accepting partial rent

*This chapter outlines the rights held by residential and nonresidential landlords to file or continue an unlawful detainer (UD) action after receipt of partial rent.*

### Chapter 18 Outline



### Chapter 18 Terms

*3-day notice to pay rent or quit*
*Accord and satisfaction*
*Estoppel*
*Nonresidential landlord*
*Nonresidential tenant*
*Nonwaiver of rights provision*
*Partial payment agreement*
*Reservation of rights*
*Unlawful detainer action*

**Residential and nonresidential landlord rights**

A *nonresidential tenant*, also called a **commercial or industrial tenant**, experiences cash flow difficulties due to a business downturn. As a result, the tenant becomes delinquent in the payment of rent.

Discussions between the landlord and tenant follow. To enforce collection of the rent, the landlord eventually serves the tenant with a *3-day notice to pay rent or quit* the premises. [See **first tuesday** Form 575]

Prior to the filing of an *unlawful detainer (UD) action*, the tenant offers to hand the landlord a partial payment of the delinquent rent. Further, the tenant wants to pay the balance of the delinquent rent by a specific date if the landlord will agree in writing to defer any filing of a **UD action**, called a *partial payment agreement.* [See Form 558 accompanying this chapter]

The **partial payment agreement** specifies the amount of deferred rent remaining unpaid, the date for its payment and the consequences of nonpayment — eviction by a UD action without

further notice. If the deferred rent is not paid as rescheduled, the *nonresidential landlord* has the agreed-to right to file a UD action to evict the tenant without repeating the **3-day notice** requirement for filing a UD action.

Here, the partial payment agreement has only temporarily delayed the **nonresidential landlord** from moving forward with the eviction process commenced by the service of the 3-day notice on the tenant.

Under the partial payment agreement, the nonresidential landlord retains his right to proceed, based on the service of the 3-day notice, by filing a UD action to evict the tenant if the deferred payment for the balance of the delinquency is not received as rescheduled.

The tenant fails to pay the deferred balance of the delinquent rent on the date scheduled for payment. Without further notice to the tenant, the landlord files a UD action.

The nonresidential tenant seeks to prevent the landlord from proceeding with the UD action, claiming the landlord's acceptance of the partial rent payment invalidates the 3-day notice since the notice now states an amount of rent which is no longer due as a result of the partial payment agreement.

Can the nonresidential landlord accept a payment of partial rent after serving a 3-day notice and later file a UD action against the tenant without serving another 3-day notice for the remaining unpaid rent?

Yes! A **nonresidential landlord** can accept a partial payment of rent after serving a 3-day notice and before filing a UD action. Without further notice to the tenant, the nonresidential landlord can commence a UD action and evict the tenant. [Calif. Code of Civil Procedure §1161.1(b)]

Further, on accepting a partial payment of delinquent rent, a nonresidential landlord does not need to agree to a due date for the remaining rent. He also does not need to enter into any agreement regarding his acceptance of the partial payment if the tenant has previously received a reservation of rights from the landlord, called a *nonwaiver provision* (which appears as a provision in nonresidential leases). [See **first tuesday** Form 552 §22]

However, the nonresidential landlord who memorializes his acceptance of the partial rent payment and the due date for payment of the unpaid balance eliminates any conflicting claims the tenant may make in a UD action concerning the tenant's expectations based on the landlord's acceptance of partial payment of rent.

### Residential property distinguished

Consider the same situation involving residential property instead of nonresidential property. As for serving a 3-day notice and later accepting partial payment of the delinquent rent, a huge distinction exists in the separate unlawful detainer rules for residential and nonresidential tenancies.

# PARTIAL PAYMENT AGREEMENT

Nonresidential

Prepared by: Agent ______________________ | Phone ______________________
Broker ______________________ | Email ______________________

**DATE:** ____________, 20_____, at ______________________________________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This partial payment agreement pertains to the collection of past due rent under a nonresidential rental or lease agreement

1.1 dated ________________, at ______________________________________________, California,

1.2 entered into by ______________________________________________________, as the Tenant, and

1.3 ____________________________________________________________, as the Landlord,

1.4 regarding leased premises referred to as ______________________________________________.

**AGREEMENT:**

**2.** Tenant has not paid delinquent rent for the period(s) of ________________________________________.

**3.** Landlord hereby accepts partial payment on delinquent rent in the amount of . . . . . . . . . . . . $______________

**4.** The balance of the delinquent rent owed is . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $______________

4.1 Plus late charges for delinquency(ies) of . . . . . . . . . . . . . . . . . . . . $______________

4.2 Plus deferred rent processing charges of . . . . . . . . . . . . . . . . . . . . $______________

4.3 **Total deferred rent** due, including additional charges, is the sum of . . . . . . . . . . . . . . $0.00

**5.** Tenant to pay the total deferred rent on or before ____________, 20_____.

5.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord.

5.2 Rent may be tendered by ☐ mail, or ☐ personal delivery,

to ______________________________________________ (Name)

______________________________________________ (Address)

______________________________________________

______________________________________________ (Phone)

a. Personal delivery of rent will be accepted during the hours of _____ to _____ on the following days:
____________________________________________________________________________.

5.3 Rent may also be paid by deposit into account number ______________________________

at ______________________________________________ (Financial Institution)

______________________________________________ (Address)

______________________________________________

5.4 No grace period for payment of the deferred rent is granted to Tenant.

5.5 Delinquent payment of the deferred rent incurs a late charge of $______________.

**6.** If deferred rent is paid when due, any outstanding three-day notice to pay rent or quit is no longer valid.

**7.** If the deferred rent is not paid when due, Landlord reserves the right to:

**(Check one box only)**

7.1 ☐ Serve Tenant with a three-day notice to pay the remaining balance of the rent due or quit the premises.
*(Check if a three-day notice has not been served)*

7.2 ☐ Commence, without further notice, an unlawful detainer action to evict Tenant from the premises.
*(Check if a three-day notice has been served)*

7.3 ☐ Continue with the unlawful detainer action on file to evict Tenant from the premises.
*(Check if unlawful detainer action has been filed)*

**8.** No provision of the rental or lease agreement is affected in this agreement.

**9.** ____________________________________________________________________________

**I agree to the terms stated above.**

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ____________, 20_____

Landlord: ______________________________

Agent: ____________________ DRE #: __________

Signature: ______________________________

Phone: __________________ Cell: ______________

Email: ______________________________

**I agree to the terms stated above.**

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ____________, 20_____

Tenant: ______________________________

Signature: ______________________________

Tenant: ______________________________

Signature: ______________________________

Phone: __________________ Cell: ______________

Email: ______________________________

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A **residential landlord** who accepts any amount of rent from a tenant after serving a 3-day notice waives his right to file a UD action based on that 3-day notice. A residential landlord must re- serve the tenant a notice for the amount now remaining unpaid. [**EDC Associates, Ltd.** v. **Gutierrez** (1984) 153 CA3d 167]

**Residential vs. nonresidential landlords**

Acceptance of a **partial payment** toward delinquent rent is within the discretion of the landlord. A landlord may be willing to accept partial payments when:

- the partial payment is at least equal to the rent accrued at the time the tenant offers the payment;
- the tenant is creditworthy;
- the tenant has an adequate payment history; and
- the tenant is one the landlord wants to retain.

Both residential and nonresidential landlords may accept a partial payment of delinquent rent, then immediately serve the tenant with a 3-day notice demanding payment of the balance due or quit. However, a landlord could agree in a partial payment agreement not to serve a 3-day notice after receipt of the partial payment of rent on the condition the balance will be received on or before a specified date. [See Forms 558 and 559 accompanying this chapter]

**Residential rent paid after notice**

If a **residential landlord** files a UD action and later accepts a partial payment of rent, the UD action cannot go forward to eviction. The reason lies in the different amounts of rent demanded in the notice to pay and the amount actually remaining delinquent at the UD hearing. In residential UD actions the amounts must be the same. This rule does not apply to nonresidential tenancies.

Once the residential landlord accepts a partial payment of delinquent rent, the 3-day notice served on the tenant and used to prove up a UD action no longer states the correct amount which must be paid by the tenant to avoid losing his right to possession.

Any 3-day notice served on a residential tenant overstating the amount of delinquent rent due at the **time of trial** on the UD action is invalid. The UD action in a residential eviction based on an overstated amount in the 3-day notice must fail. [**Jayasinghe** v. **Lee** (1993) 13 CA4th Supp. 33]

Upon acceptance of a partial payment of rent, the residential landlord must serve another 3-day notice demanding payment of the remainder due on unpaid delinquent rent, and, if not paid, file a new UD action.

## Deferring the first month's rent

Consider a landlord who locates a creditworthy tenant for his residential property.

In addition to the advance payment of the first month's rent, the landlord requires a security deposit equal to one month's rent.

The tenant asks the landlord if he can pay half the security deposit in advance and the other half with the second month's rent. The tenant is unable to pay the security deposit in full until he receives his security deposit refund from his current landlord.

The landlord wants this applicant as a tenant and is willing to extend the credit.

To be cautious, the landlord structures receipt of the funds as payment of the entire security deposit and half of the first month's rent. The tenant will pay the remaining half of the first month's rent with payment of the second month's rent.

Thus, should the tenant fail to pay either the second month's rent or the remainder of the first month's rent when due:

- the landlord may serve a 3-day notice to pay rent or quit; and
- as a last resort, the landlord may deduct the amount from the security deposit.

Conversely, consider a landlord who allows a tenant to allocate his initial payment on the lease to one full month's rent, with payment of the balance due on the security deposit spread over two or more months.

Here, should the tenant fail to pay the second installment of the security deposit, the default will not be a *material breach* of the lease or rental agreement. A *material breach* is necessary before a UD action based on service of a 3-day notice to perform can proceed to an eviction. A security deposit is not rent, although it is an amount "owed" to the landlord.

A tenant's breach must be material and relate to the economics of the rental or the lease agreement, such as a failure to pay rent, before the landlord can justify service of a 3-day notice. A minor breach of the lease, such as the failure to pay penalties for delinquence, returned check charges and deferred security deposits, will not justify serving a 3-day notice to forfeit the tenant's right to possession. The failure to pay rent and other amounts periodically paid to the landlord, such as CAMs, is a material breach supporting forfeiture of the tenant's leasehold and right to possession of the property. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

### Nonresidential nonwaiver requirements

However, should a **nonresidential landlord** file a UD action and later accept a partial payment of rent, he must then provide or have previously provided the tenant with notice that the acceptance of rent does not waive the landlord's rights, called a **nonwaiver of rights provision** or *reservation of rights*. When the tenant receives a nonwaiver of rights on or before the landlord's acceptance of partial rent, the landlord may continue with the UD action and recover possession of the premises. [CCP §1161.1(c)]

Nonresidential lease agreements include the necessary nonwaiver of rights provision, stating the landlord's acceptance of partial rent does not constitute a waiver of the landlord's right to enforce any remaining breach of the lease. [See **first tuesday** Form 552 §22]

Now consider a nonresidential tenant who defaults on a rent payment under a lease agreement containing a nonwaiver provision. He is served with a 3-day notice to pay or quit, but fails to pay the rent before it expires. The 3-day notice to pay does not contain a provision for nonwaiver of rights on acceptance of rent.

The nonresidential landlord files a UD action. He then accepts a partial payment of rent without entering into any agreements, except to receive the amount paid as rent.

The tenant now claims the landlord cannot proceed with a UD hearing since neither the 3-day notice nor the landlord's receipt of the partial rent payment include a nonwaiver of rights provision.

Here, the nonresidential landlord may proceed with the UD action after receipt of partial rent. The nonwaiver provision in the lease agreement gives the tenant notice that the landlord's acceptance of any rent does not waive the landlord's rights. One such right is the right to proceed with a previously filed UD action. [**Woodman Partners** v. **Sofa U Love** (2001) 94 CA4th 766]

A nonwaiver provision in a 3-day notice or partial payment agreement provides the landlord with the same right to proceed with the UD action as though the provision existed in the lease agreement.

On accepting a partial payment of rent after a UD action has been filed, the nonresidential landlord amends the UD complaint to reflect the partial payment received and the remaining amount now due from the tenant. [CCP §1161.1(c)]

### Get it in writing

Without a written partial payment agreement, the tenant could claim the landlord who accepted partial rent:

- treated acceptance of partial rent as an *accord and satisfaction* of all the rent due in a purported dispute over the amount of rent actually owed;

# PARTIAL PAYMENT AGREEMENT

Residential

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**DATE:** __________, 20____, at ______________________________, California.
*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This partial payment agreement pertains to the collection of past due rent under a residential rental or lease agreement
- 1.1 dated ______________, at ______________________________, California,
- 1.2 entered into by ______________________________, as the Tenant, and
- 1.3 ______________________________, as the Landlord,
- 1.4 regarding leased premises referred to as ______________________________
______________________________.

**AGREEMENT:**

**2.** Tenant has not paid the full rent due for the month(s) of ______________________________.

**3.** Landlord hereby accepts partial payment on the past due rent in the amount of . . . . . . . . . . $____________

**4.** The balance of the unpaid rent owed by Tenant is . . . . . . . . . . . . . . . . $____________
- 4.1 Plus a late charges for delinquency of . . . . . . . . . . . . . . . . . . . . $____________
- 4.2 Plus deferred rent processing charges of . . . . . . . . . . . . . . . . . . $____________
- 4.3 **TOTAL deferred rent** due, including additional charges, is the sum of . . . . . . . . . . . . . $0.00

**5.** Tenant to pay the total deferred rent on or before __________, 20____.
- 5.1 Rent to be paid by ☐ personal check, or ☐ ______________________________.
- 5.2 Rent may be tendered by ☐ mail, or ☐ personal delivery,
  ______________________________ (Name)
  ______________________________ (Address)
  ______________________________
  ______________________________ (Phone)
  - a. Personal delivery of rent will be accepted during the hours of ______ to ______ on the following days:
  ______________________________.
- 5.3 Rent may also be paid by deposit into account number ____________________
  ______________________________ (Financial Institution)
  ______________________________ (Address)
  ______________________________
  ______________________________ (Phone)
- 5.4 No grace period for payment of the deferred rent is granted to Tenant.
- 5.5 Delinquent payment of the deferred rent incurs a late charge of $____________

**6.** If the deferred rent is not paid when due, a three-day notice to pay rent or quit may be served at any time.

**7.** No provision of the rental or lease agreement is affected by this agreement.

**8.** ______________________________

**I agree to the terms stated above.**
Date: ____________, 20______
Landlord: ______________________________
Agent: ______________________________
Signature: ______________________________
Address: ______________________________
______________________________
Phone: ______________Cell:____________
Fax: ______________________________

**I agree to the terms stated above.**
Date: ____________, 20______
Tenant: ______________________________
Signature: ______________________________
Tenant: ______________________________
Signature: ______________________________
Address: ______________________________
______________________________
Phone: ______________Cell:____________

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- by his conduct waived the right to continue eviction proceedings, sometimes called *estoppel*; or
- permanently **modified** the lease agreement, establishing a semi-monthly rent payment schedule.

When a residential or nonresidential landlord accepts a partial payment of rent, the use of the partial payment agreement is evidence that bars the tenant from later claiming the landlord waived valuable rights by accepting rent.

**Residential partial payment agreement**

The partial payment agreement entered into by a residential landlord and tenant on acceptance of a portion of the rent due memorializes:

- the landlord's receipt of partial rent;
- the tenant's promise to pay the remainder of the rent on or before a rescheduled due date; and
- notification of the landlord's right to serve a 3- day notice on failure to pay the remaining balance. [See Form 559]

While the partial payment agreement does state the amount of the deferred portion of the delinquent rent owed by the tenant and the date it is to be paid, the notice is not what is required to establish an unlawful detainer and evict the tenant.

Consider a **residential tenant** who informs the landlord he will be unable to pay the monthly rent within the grace period after it is due, before the payment becomes delinquent. The tenant offers to pay part of the rent prior to delinquency and the remainder ten days later.

Since the tenant is creditworthy, has not been seriously delinquent in the past and the landlord wishes to retain the tenant, the residential landlord agrees to accept the partial payment.

However, to avoid disputes regarding the amount of remaining rent due and when it will be paid, the residential landlord prepares and the tenant signs a partial payment agreement formalizing their understanding.

Now consider a residential landlord who serves a 3-day notice and then accepts a partial payment of rent before the notice expires. By accepting a partial payment, the residential landlord has rendered the 3-day notice invalid.

When the rent was accepted the residential landlord required the tenant to enter into a partial payment agreement stating the date the balance owed was due. The partial payment agreement will avoid any claims by the tenant about when the balance is due and when a 3-day notice can be served if the balance is not paid.

**Nonresidential partial payment agreement**

The eviction rights reserved by a non-waiver provision allowing a nonresidential landlord to accept partial rent are far less restricted by law than for a residential landlord.

Before service of a 3-day notice to pay rent or quit on a **nonresidential tenant** who is delinquent in his rent payment, the nonresidential landlord can:

- accept partial payment of rent; and
- then or later serve a 3-day notice, or agree not to serve a 3-day notice unless the remainder of the rent is not paid as rescheduled. [See Form 558 §6.1]

When a 3-day notice has been served on a nonresidential tenant and the landlord later accepts a partial payment of rent, the partial payment agreement they enter into to acknowledge receipt of partial rent contains:

- the due date for payment of the delinquent rent remaining unpaid; and
- notice of the nonresidential landlord's right to file a UD action on nonpayment.

More importantly, a nonresidential landlord who **files a UD action** and later accepts a partial payment of rent under a partial payment agreement notifies the tenant that the landlord has not waived his right to continue the UD action and recover possession under the existing UD action in spite of the payment of rent. As a variation, the nonresidential landlord could agree to reinstate the tenant's right to possession if the remainder of the delinquent rent is paid prior to the UD hearing date.

However, no agreement is necessary on acceptance of partial rent from a nonresidential tenant to preserve the landlord's rights. The landlord can accept partial payment and immediately proceed with his next step in the eviction process — service of a 3-day notice, filing of the UD action or the UD hearing — if a nonwaiver provision is in a prior document, such as the lease agreement.

# Chapter 19 — Changing terms on a month-to-month tenancy

*This chapter reviews the requirements for a landlord's 30-day notice to alter the terms in a tenant's month-to-month rental agreement.*

***Chapter 19 Outline***



***Chapter 19 Terms***

| | |
|---|---|
| *30-day notice of change* | *Covenants* |
| *30-day notice of intent to vacate* | *Month-to-month rental agreement* |
| *Conditions* | *Rent control ordinances* |

**Landlord's 30-day notice to tenant**

A landlord and tenant enter into a month-to-month tenancy under a rental agreement which contains an option to purchase the property. The option **expires on termination** of the tenancy.

Later, the landlord serves the tenant with a 30-day Notice of Change in Rental Terms, stating the option to purchase will now expire in 30 days, unless exercised by the tenant. [See Form 570 accompanying this chapter]

After the 30-day notice expires, the tenant, who is still in possession, attempts to exercise the option. However, the landlord refuses to sell the property under the option, claiming the tenant's right to exercise the option to purchase no longer exists as the option expired due to the 30-day notice.

The tenant claims the option to purchase is binding for the duration of the tenancy, and the month-to-month rental agreement has not been terminated.

Can the tenant enforce the option to purchase?

No! The option expired unexercised on the running of the 30-day notice of change in rental terms which altered its expiration date.

## 30-DAY NOTICE OF CHANGE IN RENTAL TERMS

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**NOTE:** To change any terms in a month-to-month tenancy, a Landlord must furnish the Tenant with a written 30-day notice of the change. If rent is raised more than 10% within a 12-month period on a residential Tenant, a 60-day notice of the increase is required. [Calif. Civil Code §827; see **ft** Form 574]

**DATE:**__________, 20____, at ______________________________, California.
**To Tenant:** ______________________________
*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** You are a Tenant under a rental agreement or expired lease agreement
   1.1 dated ______________, at ______________________________, California,
   1.2 entered into by ______________________________, as the Tenant, and
   1.3 ______________________________, as the Landlord,
   1.4 regarding real estate referred to as ______________________________
   ______________________________.

**NOTICE:**
Thirty (30) days after service of this notice on you, the terms of your tenancy on the real estate are hereby changed as indicated below:

**2.** Rent shall be $____________ payable ☐ monthly, or ______________________________,
in advance, and due on the ______________ day of the month.
   2.1 Rent to be paid by ☐ personal check ☐ ______________________________.
   2.2 Rent may be tendered by ☐ mail, or ☐ personal delivery,
   to ______________________________ (Name)
   ______________________________ (Address)
   ______________________________ (Phone, Fax, Email)
      a. Personal delivery of rent will be accepted during the hours of _____ to _____ on the following days:
      ______________________________.
   2.3 Rent may also be paid by deposit into account number ______________________________,
   at ______________________________ (Financial Institution)
   ______________________________ (Address)

**3.** The common area maintenance charge shall be $____________ per month, payable with each payment of rent.

**4.** Utilities now paid by Landlord to be paid by Tenant as checked:
☐ Gas ☐ Electricity ☐ Sewage and Rubbish ☐ Water ☐ Cable TV

**5.** ☐ Tenant to maintain and properly care for the lawns, gardens, trees, shrubs and watering system.

**6.** An additional security deposit of $____________ is payable with the next rent payment.

**7.** Smoking is prohibited in the following area(s) ______________________________
______________________________

**8.** ______________________________
______________________________

**9. This notice affects no other terms of your tenancy.**

Date:__________, 20______
Landlord/Agent:______________________DRE #: __________

Signature:______________________________
Phone: ____________________Cell: ____________________
Fax: ______________________________
Email:______________________________

 

The option to purchase was part of the rental agreement. Thus, on expiration of the 30-day notice canceling the option, the option — as a set of terms in an addendum attached to the month-to-month rental agreement — was eliminated.

Like any other provision contained or referenced in a month-to-month rental agreement, the option to purchase is part of the month-to-month tenancy, subject to change on 30 days' written notice from the landlord. [**Wilcox** v. **Anderson** (1978) 84 CA3d 593]

**30-day notice to change rental terms**

All covenants and conditions in a residential or nonresidential month-to-month rental agreement, also called *provisions, clauses, terms, conditions, addenda, etc.*, may be changed on 30 days' written notice by the landlord. [Calif. Civil Code §827]

For example, a residential or nonresidential landlord under a month-to-month rental agreement can increase the rent or shift repair and maintenance obligations to the tenant by serving a 30-day Notice of Change in Rental Terms. [See Form 570]

To be enforceable, the 30-day notice must be served in the same manner as a 3-day notice to pay rent or quit. However, only the landlord may unilaterally change the terms in a rental agreement. [CC §827]

A month-to-month tenant has no ability to alter the terms of his rental agreement, other than to terminate the tenancy and vacate. [CC §1946]

In rent control communities, a landlord or property manager must be fully apprised of how rent control ordinances affect their ability to alter provisions in leases and rental agreements.

**30-day notice to increase rents**

A landlord or property manager may serve a notice of change in rental terms under a periodic (month-to-month) rental agreement on **any day** during the rental period.

Once a notice of change in rental terms is served on a month-to-month tenant (or other periodic tenancy), the new terms stated in the notice immediately become part of the tenant's rental agreement. [CC §827]

However, the new rental terms stated in the notice do not take effect until expiration of the 30-day notice.

For example, a property manager prepares a 30-day notice of change in rental terms to be served on a month-to-month tenant to **increase the rent**. The due date for the payment of rent is the first day of each month.

The tenant is properly served with the 30-day notice on the 10th of June. The tenant intends to remain in possession at the new rental rate.

## 30-DAY NOTICE TO VACATE

From Tenant

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**NOTE:** Unless otherwise agreed, a Tenant may terminate a month-to-month tenancy by giving thirty (30) days' written notice to the Landlord. [Calif. Civil Code §1946]

**DATE**: ____________, 20_____, at ______________________________, California.
**To Landlord:** ______________________________

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** I am a Tenant under a rental agreement or expired lease agreement
- 1.1 dated ______________, at ______________________________, California,
- 1.2 entered into by ______________________________, as the Tenant, and ______________________________, as the Landlord,
- 1.3 regarding real estate referred to as ______________________________.

**NOTICE:**

**2.** Within thirty (30) days after service of this notice, I will vacate and deliver possession of the premises to Landlord or ______________________________.

**3.** This notice is intended as a 30-day Notice to terminate my month-to-month tenancy.

**4.** I understand:
- 4.1 I will owe pro rated daily rent for any days in the 30-day period I have not prepaid rent.
- 4.2 I have previously given Landlord a security deposit of $____________.
  - a. I acknowledge, if I am a residential tenant, that I have the right to request and be present for an inspection of the premises to be conducted within two weeks of expiration of this notice to vacate for the purposes of Landlord providing me with an itemized statement of deductible charges for repairs and cleaning to allow me the opportunity to remedy these deficiencies and avoid a deduction from my security deposit. [Calif. Civil Code §1950.5(f)(1)]
  - b. Within 21 days after I vacate, Landlord will furnish me a written statement and explanation of any deductions from the deposit, and a refund of the remaining amount. [Calif. Civil Code §1950.5(g)(1)]
- 4.4 Landlord may deduct only those amounts necessary to:
  - a. reimburse for Tenant defaults in rental payments;
  - b. repair damages to the premises caused by Tenant (ordinary wear and tear excluded);
  - c. clean the premises, if necessary;
  - d. reimburse for loss, damage or excessive wear and tear on furnishings provided to Tenant.
- 4.5 Landlord may show the premises to prospective tenants during normal business hours by first giving you written notice at least 24 hours in advance of entry. The notice will be given to you in person, by leaving a copy with an occupant of suitable age and discretion, or by leaving the notice on or under your entry door.

**5.** The reason for termination is ______________________________.
(Optional)

**6.** I have served this notice on Landlord or Manager ☐ personally, or ☐ by certified or registered mail.

**This statement is true and correct.**

Date: ____________, 20_____

Tenant: ______________________________

Signature: ______________________________

Forwarding Address: ______________________________

______________________________

Phone: ______________ Cell: ______________

Fax: ______________________________

Email: ______________________________

**For Landlord/Agent's use:**

Date Received: ______________________________.

**FORM 572** 03-11 

Since June 11th is the first day of the 30-day notice period, the rent will not **begin to accrue** at the increased rate until July 11th — the day after the 30-day notice expires. However, rent for all of July is payable **in advance** on the first of the month, including the number of days (21) affected by the rent increase.

The rent due and payable in advance for the calendar month of July is prorated as follows:

- the old rate for the first ten days of the month; and
- the new rate for the remaining 21 days in the month of July.

Pro rata rent will be determined based on the number of days in the calendar month, unless the rental agreement contains a provision prorating rent on a 30-day month. [CC §14]

### Tenant responses to a change

On being served with a 30-day notice of a change in rental terms, the month-to-month tenant has three options:

- remain in possession and comply with the new rental terms;
- serve the landlord with a 30-day notice of intent to vacate and pay pro rata rent on the next due date for days remaining unpaid during the month through the end of the 30-day period to vacate; or
- remain in possession, refuse to comply with the rental terms and raise defenses, such as retaliatory eviction, in the resulting unlawful detainer (UD) action.

Consider the tenant who receives the landlord's notice but does not wish to comply with changes in the rental terms. Accordingly, the tenant serves the landlord with a 30-day Notice of Intent to Vacate. [See Form 570]

If the change in terms is a rent increase, the tenant is liable for pro rata rent at the new rate for the days after the rent increase becomes effective until the tenant's notice to vacate — payable in advance on the due date for the next scheduled payment of rent, usually the first.

### Rent control restrictions

Most rent control ordinances allow a landlord or property manager to increase the rent to:

- obtain a fair return on his investment;
- recover the cost of capital improvements to the property; and
- pass through the cost of servicing the debt on the property.

Thus, without further authority from the rent control board, a landlord may increase rent in one of three ways:

- increase rent by the maximum percentage set by ordinance;
- increase rent by the maximum percentage of the consumer price index (CPI) as set by ordinance; or
- increase rent by the maximum amount previously set by the rent control board.

Landlords of newly constructed units or individual units (single family residences/condos) may establish their own rental rates, within limitations, if they are subject to rent control ordinances established prior to 1995.

# Chapter 20 Dangerous on-site and off-site activities

*This chapter presents the duty of care a landlord has to others, on or off the property, for dangerous on-site and off-site activities.*

### *Chapter 20 Outline*



### *Chapter 20 Terms*

| | |
|---|---|
| *Liable* | *Reasonable inspection* |
| *Negligence* | *Triple-net lease agreement* |
| *Reasonable care* | *Yearly inspections* |

**Duty to all to remove on-site dangers**

A landlord, by his exercise of *reasonable care* in the management of his property, must prevent **foreseeable injury** to all others who may, for whatever reason, be on the leased premises. [**Rowland** v. **Christian** (1968) 69 C2d 108; Calif. Civil Code §1714]

If a person — a tenant, guest, invitee or trespasser — is injured due to the landlord's breach of his duty of care to remove or correct a known dangerous on-site condition, the landlord is liable for the money losses the injured person incurred due to the injury. [CC §1714]

The duty of care for others owed by the landlord **applies to all persons** on the property whether they enter the premises with or without permission or are mere social guests, unless the person is committing a felony on the property.

**Conditions imposing responsibility**

To **impose liability** on a landlord for an injury suffered by any person on the leased premises, several factors must be considered, including:

- the **foreseeability** of the type of injury suffered by the individual;
- the closeness of the **connection** between the landlord's conduct and the injury suffered;
- the **moral blame** attached to the landlord's conduct;
- the **public policy** of preventing future harm;
- the extent of the **burden** on the landlord and the **consequences** to the community of imposing a duty to exercise care to prevent the injury suffered; and
- the availability, cost, and prevalence of **insurance** for the risk involved. [Rowland, *supra*]

For example, the landlord with knowledge of a dangerous situation created by the presence of a tenant's dog is liable for injuries inflicted on others by the dog based on many of these factors. The landlord's failure to remove the dangerous condition from his property created by the dog is **closely connected** to injuries inflicted by the dog.

The landlord is sufficiently aware of the dangerous condition created by the presence of the dog to **reasonably foresee** the possibility of injury to others. Also, the landlord has the **ability to eliminate** or reduce the dangerous condition and prevent future harm by serving on the tenant a 3-day notice to remove the dog or vacate. [**Uccello** v. **Laudenslayer** (1975) 44 CA3d 504]

**Consequences of Landlord's duty to inspect**

The landlord must use reasonable care in the repair and maintenance of the leased premises to **prevent harm** to others. To accomplish this level of safety through prevention of harm, the property must be inspected by the landlord whenever **entry is available** to the landlord.

Thus, each time a landlord enters into, renews or extends a rental or lease agreement, a *reasonable inspection* of the leased premises for dangerous conditions must be completed as part of his duty of care to prevent injury to others. If the landlord fails to inspect when the opportunity exists, the landlord will be **charged with knowledge** of any dangerous condition that he should have discovered had he undertaken an inspection.

Consider a landlord and tenant who enter into a nonresidential lease agreement.

The lease agreement allows the landlord to enter the premises for *yearly inspections*. Also, the tenant is required to obtain the landlord's approval before making any improvements.

With the landlord's consent, the tenant builds a roadside marketing structure and operates a retail produce business. The structure's concrete floor is improperly constructed and unfinished. Produce is often littered on the floor.

More than a year after construction, a customer slips and falls on produce littered on the floor, injuring himself. The customer claims the landlord is liable for his injuries since the landlord's right to inspect the property puts him on notice of the dangerous condition created by produce falling on the improperly constructed and unfinished concrete floor.

The landlord claims he is not liable for the customer's injuries since he had no actual notice of the dangerous condition created by the temporary deposit of produce on the floor.

However, the landlord is liable for the customer's injuries if the construction of the concrete floor:

- is a dangerous condition; or
- poses a dangerous condition when littered with produce from a permitted use. [**Lopez** v. **Superior Court** (1996) 45 CA4th 705]

A landlord is required to **conduct an inspection** of the leased premises for the purpose of making the premises safe from dangerous conditions when:

- a lease is executed, extended or renewed; and
- the landlord exercises any periodic right to re-enter or any other control over the property, such as an approval of construction. [**Mora** v. **Baker Commodities, Inc.** (1989) 210 CA3d 771]

Here, the landlord would have observed the condition of the floor had he conducted the yearly inspection of the premises called for in the lease agreement. Thus, the landlord is liable for **slip and fall** injuries when the condition of the floor is determined to be dangerous. [Lopez, *supra*]

**A reasonable inspection on any entry**

A landlord has a duty to inspect the leased premises when he **enters the premises** for any single purpose, such as maintenance, water damage or some other exigency causing him to make an emergency visit.

While a landlord may enter the premises during the lease term, he is not required to make a thorough inspection of the entire leased premises. However, the landlord who enters will be charged with the knowledge of a dangerous condition if the condition would have been observed by a reasonable person. [Mora, *supra*]

A landlord of a leased premises containing **areas open to the public** will be liable for injuries caused by a dangerous condition in the public area if the condition would be discovered during a landlord inspection.

However, if the landlord is not responsible under the lease agreement for repair and maintenance of **nonpublic areas**, the landlord will not be liable for failing to discover a dangerous condition

occurring in nonpublic sections of a leased premises. The landlord is not required to expend extraordinary amounts of time and money constantly conducting extensive searches for possible dangerous conditions. [Mora, *supra*]

For example, a triple-net, management-free lease agreement usually transfers all responsibility for maintaining and repairing the property to the tenant.

Under a *triple-net lease agreement*, the landlord will not be liable for injuries to persons caused by a dangerous condition on the leased premises if:

- the dangerous condition came about after the tenant takes possession; and
- the landlord has no actual knowledge of the dangerous condition.

Landlords often reserve the right to conduct frequent inspections to assure that the tenant is not damaging or wasting the premises and reducing its market value. The right to enter brings with it the **obligation to inspect** for dangerous conditions. Also, the landlord may erroneously tend to overlook possible dangerous conditions he can control that are connected to the tenant's use, not maintenance, of the property.

**Knowledge of dangerous conditions**

Consider a landlord and tenant who enter into a residential rental agreement giving the tenant permission to keep a German Shepherd dog on the premises.

## Agency duties of property managers

Landlords often employ real estate licensees as *property managers*.

When acting as an agent for the landlord, the licensed **property manager** has a duty to notify the landlord of his activities and observations regarding the maintenance and management of the landlord's property. [CC §2020]

Further, the landlord is considered to have the same knowledge about the property's condition as does the property manager. [CC §2332]

Since the property manager is the landlord's representative, the landlord will be liable for the property manager's actions performed in the scope of his representation. [CC §2330]

However, the land lord is entitled to *indemnity* from the property manager should the landlord be liable for the property manager's failure to properly perform his duties and keep the landlord informed.

The property manager employed by the landlord is liable to the landlord for any money losses the landlord may suffer as a result of a breach of the property manager's agency duties owed to the landlord. [CC §3333]

After the tenant takes possession of the property, the landlord never visits the premises and has never seen the dog.

Later, an employee from a utility company enters the yard and suffers injuries when he is attacked by the tenant's dog.

The utility company employee seeks to recover money from the landlord as compensation for the injuries inflicted on him by the tenant's dog. The employee claims the landlord should have known the dog is dangerous since German Shepherds are a breed with the propensity for viciousness.

Is the landlord liable for the employee's injuries?

No! The landlord did not have knowledge the tenant's dog was vicious and presented a danger to others. [**Lundy** v. **California Realty** (1985) 170 CA3d 813]

A landlord's obligation to prevent harm to others arises only when the landlord is aware of or should have known about the dangerous condition and failed to take preemptive action.

For example, the landlord receiving complaints from neighbors about the behavior of a tenant's dog may deduce the dog creates a dangerous condition, even if the dog has not yet injured anyone.

*Editor's note — The landlord's duty to protect others from an injury inflicted by a dog does not yet include asking the tenant if his dog is dangerous.*

*However, it is feasible the legislature could enact a law or the courts could impose a duty of inquiry on landlords when authorizing the tenant to keep a dog on the premises.*

*The pet authorization provision in the rental or lease agreement could include a declaration that the authorized pet is not dangerous.*

*Further, the owner of a dog is neither civilly nor criminally liable for a dog bite suffered by a person who enters the dog owner's property, lawfully or otherwise, unless the person invited onto the property by the owner of the dog is an employee of a utility company, a police officer or a U.S. mailman. [CC §3342(a)]*

### Landlord should have known

Now consider a landlord who leases nonresidential property to a tenant who operates a retail sales business on the property. The tenant keeps a dog on the premises and posts a "Beware of Dog" sign. A newspaper article written about the dog's vicious temperament is also posted on the premises. The landlord visits the leased premises several times a year and knows the dog is kept in the public area of the premises.

After the lease is renewed, a delivery man is attacked and injured by the dog. The delivery man claims the landlord must compensate him for his injuries since the landlord has a duty to inspect the property, ensuring safety for members of the public to enter.

The landlord claims he is not liable since he was personally unaware the dog was dangerous.

Is the landlord liable for the delivery man's injuries?

Yes! The landlord owes a duty to the delivery man as a member of the public to:

- exercise reasonable care in the inspection of his property **to discover** dangerous conditions; and

**Figure 1**

***first tuesday*** *Form 576, Three-Day Notice to Perform or Quit*

**THREE-DAY NOTICE TO PERFORM OR QUIT**

**Prepared by: Agent** ________________ **Phone** ________________
**Broker** ________________ **Email** ________________

**NOTE:** A tenant who fails to perform any terms of the rental or lease agreement which can be performed or rectified must within three (3) days after service of written notice of the breach, either cure the breach or vacate and deliver possession of the premises to the landlord. [Calif. Code of Civil Procedure §1161(3)]

**DATE:** ____________, 20______, at ______________________________, California.

**To Tenant:** ______________________________________________

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** You are a Tenant under a rental or expired lease agreement

1.1 dated ________________, at______________________________, California,

1.2 entered into by ______________________________, as the Tenant, and ______________________________, as the Landlord,

1.3 regarding real estate referred to as ______________________________ ______________________________.

**NOTICE:**

**2.** You are in breach of the terms of your rental or lease agreement as follows:______________________________ ______________________________ ______________________________.

**3.** Within three (3) days after service of this notice, you are required to either:

3.1 Perform or rectify the breach by ______________________________ ______________________________ ______________________________.

**OR**

3.2 Deliver possession of the premises to Landlord or ______________________________ ______________________________.

**4.** If you fail to cure the breach or to deliver possession within three (3) days, legal proceedings may be initiated to regain possession of the premises and to recover the rent owed, treble damages, costs and attorney fees.

**5.** Landlord hereby elects to declare a forfeiture of your lease if you fail to cure the breach noted above.

5.1 Landlord reserves the right to pursue collection of any future rental losses allowed by Calif. Civil Code §1951.2.

Date:____________, 20______

Landlord/Agent:______________________DRE #:____________

Signature: ______________________________

Address: ______________________________
______________________________

Phone: ________________Cell: ________________

Fax: ______________________________

Email: ______________________________

FORM 576 03-11 , P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

- remove or otherwise **eliminate** the dangerous condition that may be created by the presence of a vicious dog.

The injured person can recover when the landlord is personally unaware of the dog's vicious propensities since a reasonable inspection of the premises on renewal of the lease would have revealed to the landlord the newspaper article and the "Beware of Dog" sign. [**Portillo** v. **Aiassa** (1994) 27 CA4th 1128]

Also, it is foreseeable that a guard dog kept on premises during business hours could injure someone.

Further, the landlord's failure to require the tenant to remove the dog from the premise on discovery that the dog constitutes a dangerous condition is closely connected to the delivery man's injuries.

The landlord had control over the condition since he could serve a 3-day notice on the tenant, requiring the tenant to either remove the dog from the premises during business hours or vacate the premises.

*Editor's note — In Portillo, the court held moral blame is attached to the landlord's conduct because of his failure to remove a condition he should have known was dangerous and over which he had control.*

Also, a landlord can often remove a dangerous condition by merely exercising his responsibility to make repairs that will eliminate the condition. However, a dangerous condition caused by a tenant's activity may require a 3-day notice ordering the tenant to correct or remove the dangerous condition, or vacate the premises. [See Figure 1]

### On-site danger leads to off-site injury

Now consider a landlord and tenant who enter into a rental agreement for a residential dwelling. The agreement allows the tenant to keep dogs on the premises.

After the tenant occupies the residence, the landlord visits the premises monthly to collect the rent payments. During his visits, the landlord observes the dogs. The landlord is aware of the dogs' vicious nature.

One day, a neighbor and his dog are attacked and injured by the tenant's dog two blocks away from the leased premises. The neighbor demands the landlord pay for losses resulting from the injuries. The neighbor claims the landlord owes him a duty of care to prevent injuries arising from dangerous animals the tenant keeps on the landlord's premises.

The landlord claims he is not *liable* since the injuries occurred off the leased premises.

Here, the landlord is liable for the off-site injuries since the landlord:

- was aware of the vicious propensities of dogs housed on his premises; and

- had the ability to remove the dangerous condition by serving a 3-day notice on the tenant to remove the dogs or vacate the premises. [**Donchin** v. **Guerrero** (1995) 34 CA4th 1832]

The landlord's liability for injuries inflicted by a tenant's dog while it is off the premises is the same as his liability for injuries inflicted by the dog that occur on the premises.

While the landlord did not have control over the property where the injury occurred, the landlord did have control over the tenant's right to keep and maintain a known dangerous condition — the dogs — on the premises.

The landlord's failure to have dangerous dogs removed from the premises caused the injuries suffered by the neighbor. The injury would not have occurred if the landlord had not allowed the dogs, which he knew to be vicious, to remain on the premises he controlled. [Donchin, *supra*]

**Tenant's dangerous on-site activity**

Consider a landlord who is aware the tenant of his single-family rental unit occasionally discharges a firearm in the backyard. One day, a bullet fired by the tenant enters the backyard of the neighboring residence and kills the neighbor.

The neighbor's spouse makes a demand on the landlord for her financial loss resulting from her husband's death. The spouse claims the landlord breached his duty to individuals on neighboring property by failing to exercise care in the management of his property when he did not remove the known dangerous activity from the premises.

Is the landlord liable for the neighbor's death that occurred off the premises?

Yes! Even though the injury occurred off the leased premises, the landlord is liable since the landlord:

- knew of the dangerous on-site activity carried on by the tenant which inflicted the injury; and

- had the ability to eliminate the dangerous condition by serving a 3-day notice on the tenant to refrain from discharging the gun or quit the premises. [**Rosales** v. **Stewart** (1980) 113 CA3d 130]

Thus, the landlord had a duty to prevent the tenant from continuing to fire the gun on the premises. The landlord is liable for an injury resulting from a known dangerous condition or activity occurring on his property that he has the ability to remove, regardless of whether the injury from the on-site activity is suffered on or off the leased premises.

However, had the tenant left the landlord's premises with his gun and then shot and killed an individual, the landlord would not be liable. [**Medina** v. **Hillshore Partners** (1995) 40 CA4th 477]

### Failure to avoid obvious dangers

Some dangerous conditions are obvious to persons entering or using the premises that impose a duty of care on that person to avoid injury to themselves.

For example, a person wearing cleats walks on a concrete path alongside of which is a rubber walkway for use to prevent slip and fall injuries. The person wearing cleated shoes walks on the concrete path and slips, injuring himself in the fall. A sign does not exist explaining the danger of the person's activity.

Here, a landlord has no duty to warn or guard others against a dangerous condition that is obvious. [**Beauchamp** v. **Los Gatos Golf Course** (1969) 273 CA2d 20]

While a landlord must compensate others for injuries caused by his failure to use skill and ordinary care in the management of his property, the liability has its limits.

A person, who willfully or by his own **lack of ordinary care** to protect himself brings an injury upon himself, exonerates the landlord, wholly or in part, from liability. [CC §1714]

Thus, a person has a duty of care to himself to be sufficiently observant and keep himself out of harm's way.

When the injured person's lack of care for himself contributes to his injury, recovery for his losses is limited to the percentage of the negligence attributed to him, called comparative negligence. The money losses recoverable by the injured person will be diminished in proportion to the percent of negligence attributable to the injured person for causing his own harm by failing to care for himself. [**Li** v. **Yellow Cab Company of California** (1975) 13 C3d 804]

Consider a trespasser who illegally enters into or onto property and fails to conduct himself with care to avoid harming himself, called *negligence*.

When the trespasser is negligent in exercising care in his conduct to prevent harm to himself while entering or moving about the property, any losses recoverable by the injured trespasser will be reduced by the percentage amount of negligence attributed to him for causing his injury. [**Beard** v. **Atchison, Topeka and Santa Fe Railway Co.** (1970) 4 CA3d 129]

### Not a dangerous condition

Now consider a person who enters leased nonresidential property and wants to look inside the building.

Next to the building, below a window, stands a vat of acid maintained by the business authorized to operate on the leased premises. The vat is covered with plywood for the purpose of keeping out dirt and dust.

In order to see through the window, the person climbs up and steps onto the plywood cover which immediately collapses. The person falls into the vat, suffering injuries.

The injured person attempts to recover money from the landlord for losses resulting from his injury.

Here, the landlord is not liable for the person's injuries since the vat is not a dangerous condition that presents a risk of harm. The vat of acid is an integral part of the business run on the leased premises and is not a danger to any person who conducts himself with care around the vat.

Thus, the injured person undertook the risk of harm to himself by climbing on top of the vat and creating the dangerous situation leading to his injuries. [**Bisetti** v. **United Refrigeration Corp.** (1985) 174 CA3d 643]

*Editor's note — In Bisetti, the injured person happened to be a trespasser.*

Consider a landlord of an apartment complex used by gang members as a hangout and base from which they commit criminal offenses when off the premises. One of the gang members is a named tenant on the rental agreement.

The tenants and law enforcement officials complain to the landlord about the gang. However, the gang members do not harm or pose a threat of danger to the tenants.

Later, a pedestrian walking past the complex in the public right of way is chased by the gang members. One of the gang members, who is not the tenant, shoots and kills the pedestrian on a street adjacent to the complex.

The spouse of the pedestrian claims the landlord is liable for the death since he failed to remove the dangerous condition, the presence of gang members, from his premises.

However, the landlord does not have a duty to protect members of the public using adjacent public streets from assaults by gang members who congregate on his leased premises. [Medina, *supra*]

The congregation of gang members on the leased premises is not itself a dangerous condition. The gang members do not pose a physical threat to others of which the landlord is aware.

Thus, the landlord's failure to take steps to prevent the gang members from congregating on the leased premises is not the cause of the off-site shooting of a pedestrian by one of the gang members.

Again, the landlord is not liable for injuries inflicted by individuals that occur off the leased premises, since the landlord has **no control over the activities** of individuals or tenants while they are on public property, only when they are on his property. [Medina, *supra*]

**Dangerous off-site conditions**

Now consider a landlord who leases a residence to a tenant. The residents of the neighboring property own a dog the landlord knows to be vicious. The neighbor brings his leashed dog onto the leased premises. The neighbor invites the tenant's child to pet the dog.

The dog breaks free from the leash and attacks the child, causing injuries. The tenant claims the landlord is liable for his child's injuries since the landlord failed to warn him of the dangerous condition created by the neighbor's vicious dog.

Is the landlord liable for injuries inflicted on-site by the neighbor's dog, which he knew was vicious?

No! The dangerous condition was not maintained on the leased premises. Thus, the landlord has no control or authority himself to remove the dangerous condition from the neighbor's property. [**Wylie** v. **Gresch** (1987) 191 CA3d 412]

While a landlord owes a duty to others to remove a dog from his property that he knows to be dangerous, he does not have a duty to warn his tenants of the presence of vicious animals located on other properties in the neighborhood over which he has no control.

The landlord's failure to protect the tenant by warning him about the neighbor's dog did not create a dangerous condition on the leased premises that caused the tenant to be injured. A landlord's duty to correct or prevent injury from dangerous conditions does not extend to the dangerous conditions that exist off the premises. [Wylie, *supra*]

While the landlord has a duty to make the leased premises safe by removing dangerous on-site conditions and properly maintaining the premises, he is not the insurer of the tenant's safety from off-site hazards. [**7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901]

**Off-site injuries under landlord control**

The public right of way for a street fronting leased premises includes part of the front lawn, located between the street curb and the property line. The landlord maintains the entire lawn up to the curb.

A water meter is located on the lawn in the street right of way. Several tenants inform the landlord the water meter box is broken and needs repair.

A tenant trips on the broken water meter box and suffers injuries. The tenant makes a demand on the landlord for losses caused by his injuries, claiming the landlord has a duty to eliminate dangerous conditions located in the public right of way within the lawn maintained by the landlord.

The landlord claims he is not liable since the water meter box is not located on his property and the landlord does not own or control the meter box.

However, the landlord is liable for the injuries suffered by the tenant caused by dangerous conditions — the broken water meter box — located in a public right of way surrounded by a lawn created and maintained by the landlord. [**Alcaraz** v. **Vece** (1997) 14 C4th 1149]

Also, a landlord or other property owner who installs and maintains trees adjacent to or in the lawn area between the public sidewalk and the street-side curb owes a duty of care to avoid injuring pedestrians by hazards created by the trees he maintains.

For example, trees planted and maintained by the property owner grow and eventually produce roots that extend under the sidewalk and crack and uplift it. The owner is aware of the hazard created by the tree roots but undertakes no steps to have the hazardous condition repaired or replaced.

Here, the owner has taken control over the off-site area containing the public sidewalk and will be liable to any pedestrian who is injured due to the hazard created by the roots of trees he maintains since the trunks of the trees are located on his property. [**Alpert** v. **Villa Romano Homeowners Association** (2000) 81 CA4th 1320]

# SECTION G

## Financing

# Chapter 21 — Rates affecting real estate

*This chapter is an overview of the rates and figures that impact real estate sales, leasing and financing decisions.*

***Chapter 21 Outline***

*The influence of Federal Reserve policies*
*The discount rate*
*Federal funds*
*1-year T-bills and the 11th District Cost-of-Funds*
*Prime rate*
*CPI, rents and resale pricing*
*The AFRs*

***Chapter 21 Terms***

| | |
|---|---|
| *11th District Cost-of-Funds* | *Federal funds* |
| *Applicable Federal Rate* | *Maximum annual interest rate* |
| *Consumer Price Index* | *Prime rate* |
| *Discount rate* | |

**The influence of Federal Reserve policies**

The rates reviewed here are commonly used in real estate transactions. For instance, the *Consumer Price Index* (CPI) is used as an inflation index to adjust rents, allowing the landlord to retain his purchasing power from year to year.

The components of the various interest rates, index figures and the Federal Reserve's policies used in an attempt to control the economy are often confused or unknown to the reader.

**The discount rate**

The *discount rate* is the interest rate the Federal Reserve charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements. [See Figure 1]

The **discount rate** is important to private money lenders who are:

- not licensed real estate brokers; and
- do not arrange their loans through real estate brokers.

## Figure 1 Real estate related rates
## Actual figures: current, last month, a year ago

Smartphone users may scan this QR-Code for chart updates.

### 6-month Treasury bill average auction rate

| Current | Month ago | Year ago |
|---|---|---|
| 5/2012 | 4/2012 | 5/2011 |
| 0.15% | 0.14% | 0.09% |

ARM interest rate equals 6-month T-bill rate (at time of adjustment or an average of several prior rates) plus the lender's profit margin.

### Treasury securities average yield — 1-year constant maturity

| Current | Month ago | Year ago |
|---|---|---|
| 5/2012 | 4/2012 | 5/2011 |
| 0.19% | 0.18% | 0.19% |

ARM interest rate equals T-bill yield plus the lender's margin. The index is an average of T-bill yields with maturities adjusted to one year.

### Cost-of-funds index 11th F.H.L.B.B. District
**(for May 2012)**

| Current | Month ago | Year ago |
|---|---|---|
| 1.14% | 1.16% | 1.45% |

ARM interest rate equals cost-of-funds plus the lender's profit margin. Current index reflects cost-of-funds two months prior.

### Prime rate

| Current | Month ago | Year ago |
|---|---|---|
| 5/2012 | 4/2012 | 5/2011 |
| 3.25% | 3.25% | 3.25% |

The prime rate is used by banks to price short-term business loans and set ARMs tied to the prime rate.

### Discount rate — Federal Reserve Bank of San Fransico

| Current | Month ago | Year ago |
|---|---|---|
| 5/2012 | 4/2012 | 11/2011 |
| 0.75% | 0.75% | 0.50% |

Usury law limits the annual interest yield on non-exempt loans to 10% or the discount rate plus 5% whichever is greater. The discount rate is charged on loans made by the Federal Reserve bank to its members.

### 12-month Treasury Average

| Current | Month ago | Year ago |
|---|---|---|
| 5/2012 | 4/2012 | 5/2011 |
| 0.15% | 0.15% | 0.26% |

ARM interest rate equals T-bill average yield plus the lenders margin. The index is an average of the one-year T-bill rates for the past 12 months.

### Average 30-yr conventional commitment rate for West Region for week ending:

| Current | Month ago | Year ago |
|---|---|---|
| 7/5/2012 | 6/7/2012 | 7/7/2011 |
| 3.56% | 3.63% | 4.53% |

The average 30-yr commitment rate is the rate at which a lender commits to lend mortgage money in the West Region as reported by FHLMC.

### London Inter-Bank Offered Rate
**(for May 2012)**

| 1 month | 6 month | 1 year |
|---|---|---|
| 0.24% | 0.74% | 1.07% |

ARM interest rate equals the LIBOR rate plus the lender's margin. The rate is set by the banks in London, England.

### 10-year T-Notes — average market yield for week ending:

| 7/03/2012 | 6/5/2012 | 7/7/2012 |
|---|---|---|
| 1.65% | 1.57% | 3.16% |

The rate is a leading indicator of the direction of future FHLMC rates. The rate is comprised of the level of word wide demand for the dollar and anticipated future domestic inflation

### Applicable Federal Rates
**(monthly payments)**
**June 2012**

| Short (up to 3 yrs.) | Medium (3 to 9 yrs.) | Long (9 + yrs.) |
|---|---|---|
| 0.26% | 1.16% | 3.02% |

Determines minimum interest rates imputed interest rates on non-exempt carryback financing. The AFR category is determined by the carryback due date.

### Consumer Price Index — Urban Consumer (CPI-U)
**(1967 = 100)**

| San Francisco | | Los Angeles | |
|---|---|---|---|
| Apr. 2011 | 719.752 | Apr. 2011 | 689.327 |
| Apr. 2012 | 734.506 | Apr. 2012 | 699.806 |
| Annual Change | +2% | Annual Change | +1.5% |

The periodic percentage change in the consumer price index (CPI) is a measure of domestic inflation, and is used to measure price movements among goods and services associated with the consumer's cost of living.

The discount rate is a component of the interest rate limits imposed by usury laws on non-brokered, private money real estate loans. The discount rate component for usury limits is set each month and is the rate effective on the 25th day of the previous month.

For example, on August 15, 1999, the discount rate rose from 4.50% to 4.75%. Thus, the September 1999 discount rate was 4.75%.

The discount rate for the life of the loan is the rate for the month in which the loan agreement is entered.

The maximum annual interest rate on non-exempt loans secured by real estate is the greater of:

- 10% per year; or
- the discount rate plus 5%. [California Constitution, Article XV §1]

The discount rate for the applicable month is useful to the non-exempt lender, not licensed as a real estate broker nor employing a broker - when the discount rate exceeds 5%.

**Federal funds**

*Federal funds* are overnight funds lent in the **federal funds** market by one bank with excess reserves to another bank with insufficient reserves.

The Federal Reserve influences the movement of the federal funds rate by affecting the supply of bank reserves, through buying or selling government securities, typically *one-year T-bills*.

When the Fed wants to tighten monetary policy to cut inflation, it will sell government securities to reduce bank reserves, causing the federal funds rate to increase.

An increase in the federal funds rate will cause rate increases in other short-term money instruments such as treasury bills, certificates of deposits (CDs) and repurchase agreements (RPs).

Both the discount rate and the federal funds rate are tools used by the Federal Reserve to control short-term interest rates. Increases in short-term rates are spurred by the Federal Reserve Board's perception that higher consumer price inflation looms in the future due to an excessive demand for goods and services.

By increasing the short-term rates, the Fed intends to slow down the economy by limiting the availability of credit through the increased cost of borrowing.

**1-year T-bills and the 11th District Cost-of-Funds**

The figures for **one-year T-bill** indexes are based on the sale of T-bills through the money markets. In contrast, the *11th District Cost-of-Funds* is the average cost of funds for 11th District savings institutions. The one-year T-bills and the **11th District Cost-of-Funds** are used as indexes for setting the rates from time to time on adjustable rate mortgages (ARMs).

Rates on one-year T-bills are more volatile and rise and fall faster than the steadier 11th District Cost-of-Funds. With the ability of banks to borrow from the Fed at rates designed in part to protect the solvency of banks during recessionary time and fight inflation during boom times, the **one-year T-bill** rate has become volatile making ARMs a very risky loan for wage earners.

Entering periods of increasing rates, such as 2005 to 2007, lenders prefer the faster upward movement of the one-year T-bill indexes for increasing their yield and maintaining portfolio value.

### Prime rate

Also used as an index for ARMs, particularly equity loans, is the *prime rate*, to which a margin of two or three percent is added for monthly adjustments in interest charges.

The **prime rate** is a base rate used by banks to price short-term business loans, set at 3% above the fed funds rate. As short-term interest rates increase, so goes the prime rate. In addition to ARMs, lines of credit are commonly indexed to the prime rate.

### CPI, rents and resale pricing

Inflation is a rise in the price level of goods and services demanded in the US economy. The Consumer Price Index (CPI) is maintained by the federal government to measure price inflation levels. In real estate, the CPI for all urban consumers (CPI-U) is often used to calculate periodic rent adjustments in rent control and nonresidential leases, in lieu of fixed graduated annual percentage adjustments in rent.

When using the CPI-U for rent adjustments, the owner is compensated for the annual loss in the dollar's purchasing power as orchestrated by the Fed.

Further, long-term interest rates (10 and 30 year bonds) are influenced by the expected future rate of consumer inflation. The long-term interest rates reported on the rate page are:

- the average 30-year conventional commitment rate for the Western region as reported by Freddie Mac;
- Moody's Corporate bonds; and
- 10-year Treasuries.

The Federal Reserve only infrequently takes direct control over long-term interest rates, but they did during 2009 and 2010 following the Great Recession of 2008. However, the Fed's attempts to control inflation through its monetary policy exercised by moving the short term rates influence the expected future inflation rates, which in turn are reflected in long-term interest rates.

For example, the Fed began to increase short-term interest rates in mid-2004 and continued through 2005 to fight what the Fed perceived to be inflationary pressures in the economy brought about by demand and pricing (and the recovery of foreign markets, weakening dollar, etc.).

Due to a general view within the bond market that inflationary pressures existed in the national economy, and controversy over whether the Fed had the desire or tenacity to control the perceived inflationary pressures, long-term interest rates began to rise — and rose rapidly from October 1998 through fall 1999.

However, with short-term interest rates steadily increasing, inflationary fears are lessening and long-term interest rates stabilize and drop.

**The AFRs**

Imputed interest reporting establishes the *Applicable Federal Rate* (AFR) of interest for debt carried back by a seller on an installment sale. An interest rate on a carryback note, which is below the **AFR**, triggers imputed interest reporting to the IRS. Thus, profit is shifted to interest income.

The imputed rate is the lesser of the AFR for the month the purchase agreement is entered into, or 9%.

Twelve AFRs are set monthly by the IRS. The due date of the note and the periodic payment schedule determine the note's minimum reporting rate. For example, notes due in three or less years, payable quarterly, fall into the short-term AFR category at its quarterly rate.

# Chapter 22 A lender's loan commitment

*This chapter analyzes a borrower's reliance on a lender's oral or written commitment to fund a loan.*

***Chapter 22 Outline***

*No responsibility for oral or conditional promises*
*Commitment upon commitment*

***Chapter 22 Terms***

| | |
|---|---|
| *Oral assurances* | *Take out loan* |
| *Regulation Z* | *Written loan commitment* |

## No responsibility for oral or conditional promises

An owner of industrial land and a manufacturing business he operates on his property applies for a loan from an institutional lender to upgrade and expand his production facilities, and construct additional improvements on the property. The owner has a long-standing business relationship with the lender, having borrowed from them several times over the years.

The lender's loan officer, after processing the loan application, *orally assures* the owner they will provide the long-term financing he will need, called a *take out loan*, to pay off short-term interim financing he will obtain to fund the purchase of equipment and cost of construction. Relying on the lender's **oral assurances**, the owner enters into a series of short-term loans and credit arrangements with other lenders and suppliers, and begins the planned improvements.

The loan officer visits the owner's plant during the construction and placement of equipment. The officer comments favorably on the work in progress and again assures the owner the lender will provide the long-term financing sought by the owner.

When completed, the owner makes a demand on the lender to fund the permanent financing. The lender refuses, informing the owner the business no longer has the value needed to justify the long-term financing since **operating costs** and a **business recession** have decreased the value of the owner's facilities.

The owner is unable to obtain refinancing elsewhere, and the business and real estate is lost on default in the short-term financing. The owner seeks to recover his money losses from the lender, claiming the lender breached its commitment to provide financing.

Can the owner recover damages from the lender?

No! The lender never entered into an enforceable *loan commitment*. Nothing was placed in writing or signed by the lender which **unconditionally committed** the lender to the specific terms of a loan.

Even though the lender **orally assured** the owner a loan would be funded, and despite the owner's reliance on his pre-existing business relationship with the lender to fund his expansion, the owner was not justified in relying on the lender's oral commitment to fund a loan. [**Kruse** v. **Bank of America** (1988) 202 CA3d 38]

Lenders rarely make written **loan commitments**. When lenders do, they are limited to federally mandated nonbinding disclosures on single family residence (SFR) loans under *Regulation Z*, also known as the Truth-in-Lending Act (TILA).

Lenders customarily process applications and prepare loan documents, but they are only signed by the borrower. The lender orally advises the borrower whether the loan has been approved, but signs nothing that binds them. The first and only act committing the lender is its actual funding of the loan — at the time of closing.

Thus, until the lender literally delivers funds and a closing has occurred, the lender can back out of its oral commitment at any time, without liability.

As a result, the balance of power is entirely with the lenders. Thus, mortgage borrowers are forced to rely on unenforceable oral promises when making financial decisions in real estate transactions.

When a lender breaches its oral commitment to lend, the borrower's reliance on anything less than an **unconditional written loan commitment** is not legally justified — even though the borrower had no realistic choice other than to rely on the lender's oral promises.

As a result, prudent borrowers and their agents submit loan applications to more than one lender to guard against these sorts of last-minute surprises.

### Commitment upon commitment

The only other course of action a borrower could reasonably undertake is to purchase a **written loan commitment**, paying for the assurance funds will be advanced on the borrower's request. However, these commitments, which are *put options,* are always conditional, never absolute. The lender is allowed to deny a loan even after delivering a written loan commitment to the borrower — again, without liability.

Here's why. A borrower seeks a loan to purchase real estate and the business opportunity located on the premises. The borrower pays $10,000 for a **written conditional loan commitment** from a lender — a letter signed by the lender indicating the lender's intention to fund the loan, based on the satisfaction of a number of conditions, including:

- an appraisal of the personal property and real estate which is to secure the loan;
- the seller, who is carrying back a second, must approve the terms of the loan agreement;

- the borrower must deliver copies of all documents affecting the lender's decision, such as security agreements, guarantees, title reports, trust deeds, and leases, for the lender's approval; and

- approval of the loan by the lender's senior committee.

Later, the lender **verbally assures** the borrower the loan will be funded, stating the members of the senior committee have all approved the loan and all other conditions have been met.

However, when the borrower asks the lender to proceed to close the loan, the lender does not waive the conditions. Ultimately, on demand from the borrower for the funds, the lender refuses to fund the loan.

The borrower is able to obtain another loan from his back-up lender, but on less favorable terms than set out in the lender's written commitment. The borrower seeks to recover his money losses from the lender who refused to fund his loan application, claiming the lender breached its written loan commitment.

The lender claims it did not breach its written commitment since the commitment was conditional.

Can the borrower recover his losses from the lender?

No! Even though the borrower paid the lender for a written conditional loan commitment, the lender never agreed to a final and unconditional written commitment.

Thus, the lender escapes liability for failure to perform on its commitment, despite oral assurances to the borrower it would fund the loan agreed in writing. [**Careau & Co.** v. **Security Pacific Business Credit, Inc.** (1990) 222 CA3d 1371]

# Chapter 23 Special provisions for a promissory note

*This chapter presents provisions which may be added to a promissory note, as supplements to the basic provisions in regular note forms.*

***Chapter 23 Outline***



***Chapter 23 Terms***

*Balloon payment note*
*Call provision*
*Choice-of-law provision*
*Compound interest*
*Default interest rate*
*Late charge*
*Equitable assignment*
*Exculpatory clause*
*Prepayment penalty*
*Put option*
*Right of first refusal*
*Statutory grace period*
*Subrogation*

**Beyond fundamental debt obligations**

A *promissory note* contains a buyer's **promise to pay** a private lender or carryback seller the principal amount of the debt agreed to, plus any interest. The note is **evidence** the debt exists.

The schedule and conditions for payment of the principal and interest are also contained in the note.

In contrast, provisions in a *trust deed*, besides referencing the note and describing the real estate liened to secure the debt, primarily address the **maintenance and preservation** of the note-holder's *security interest* in the real estate.

Special provisions added to a note serve to:

- **protect** the noteholder against risk of loss due to late payments, early payoff or other defaults on the note; and
- **comply** with statutorily mandated provisions for controlled transactions.

Special provisions to be considered for inclusion in a **promissory note** include:

- a prepayment penalty [See Figure 1];
- due date extension [See Form 418-3 §2.2 accompanying this chapter; see **first tuesday** Form 425];
- compounding on default [See Figure 2 §2.6];
- balloon payment notice [See Form 418-3];
- grace period and late charges [See Figure 2];
- option for payoff discount [See Figure 3];
- right of first refusal on sale on the note [See Form 418-4 accompanying this chapter];
- reference to a guarantee agreement [See Figure 4 §2.1];
- exculpatory clause [See Figure 4 §2.2]; and

**Figure 1**

*Excerpt from **first tuesday** Form 418-2 –*
*Prepayment of Principal Provisions*

2.1 *For owner-occupied, one-to-four residential units*:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made/-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and nonresidential property*:

☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of ______% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

## FINAL/BALLOON DUE DATE PROVISIONS

Prepared by: Agent ______________________________ Phone ________________________
Broker ______________________________ Email ________________________

**DATE:** _____________, 20______, at ________________________________________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____________, 20______ at ______________________________, California,

1.2 entered into by ___________________________________________________________, as the Payor,

1.3 in favor of ___________________________________________________________, as the Payee, and

1.4 secured by a trust deed on real estate referred to as __________________________________________

________________________________________________________________________________.

**AGREEMENT:**

**2.** In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For final/balloon payment notes secured by one-to-four unit residential property*:

☐ This note is subject to Calif. Civil Code §2966, which provides that the holder of this note shall give written notice to Trustor, or his successor(s) in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due.

2.2 *For extending the due date for a final/balloon payment*:

☐ The due date will be extended for ______ year(s) if:

a. ☐ all monthly installments due within ______ month(s) of the final/balloon payment due date have been received prior to their delinquency.

b. ☐ ____________________________________________________________________________

________________________________________________________________________________

________________________________________________________________________________

| | |
|---|---|
| Payor's name: ________________________________ | Payor's name: ________________________________ |
| Signature: ___________________________________ | Signature: ___________________________________ |
| Payor's name: ________________________________ | Payor's name: ________________________________ |
| Signature: ___________________________________ | Signature: ___________________________________ |

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- governing law. [See Figure 4 §2.3]

**Prepayment penalties**

A prepayment penalty is a charge voluntarily incurred by agreement when a debtor pays off principal on a note before the principal is due by the terms of the note.

A prepayment penalty is enforceable if it is reasonably related to money losses suffered by a private lender or carryback seller, such as the payment of profit taxes incurred by a carryback seller on a premature reduction in principal or final payoff. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

The amount of the prepayment penalty the private lender or carryback seller can charge depends on:

- the **type** of property; and
- the owner's **use** of the property.

**Figure 2**

*Excerpt from **first tuesday** Form 418-1 —*
*Late Payment Provisions*

2.1 *For an owner-occupied, single family residence*:

☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:

☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If any installment on this note is not received ☐ when due, or ☐ within ______ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $_______________, or ☐ ______% of the delinquent principal and interest installment amount.

2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:

☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of ______%.

2.6 *For compounding interest on a default on other than one-to-four residential units*:

☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

# RIGHT OF FIRST REFUSAL TO BUY NOTE

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**DATE:** __________, 20_____, at ________________________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This is an addendum to a promissory note

1.1 ☐ of same date, or dated __________, 20_____, at ____________________, California,

1.2 entered into by ________________________________________, as the Payor,

1.3 in favor of ________________________________________, as the Payee, and

1.4 secured by a Trust Deed on real estate referred to as ______________________________
________________________________________________________________.

**AGREEMENT:**

**2.** In addition to the terms of the above referenced Note and Trust Deed, Payor agrees to the following:

**Right of first refusal to buy:**

**3.** Payee hereby grants Payor a right of first refusal to purchase the Note and Trust Deed.

**4.** Should Payee decide to sell an interest in the Note and Trust Deed, Payee shall notify Payor of the terms on which Payee is willing to sell and assign the Note and Trust Deed.

4.1 Payor has the option, for a period of _____ days after receiving notice, to purchase the Note and Trust Deed on the terms stated in the notice.

4.2 Should Payor fail to exercise the option within the option period, Payee has the right to sell the Note and Trust Deed to a third party on the same terms stated in the notice to Payor.

4.3 Any sale on different terms reinstates the right of first refusal.

**5.** If the Note and Trust Deed is not sold and assigned within six months after Payor's receipt of notice, the right of first refusal is reinstated.

**6.** ________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________

| **Payor: I agree to the terms stated above.** | **Payee: I agree to the terms stated above.** |
|---|---|
| Date: __________, 20_____ | Date: __________, 20_____ |
| Payor's Name: ____________________ | Payee's Name: ____________________ |
| Signature: ____________________ | Signature: ____________________ |
| Payor's Name: ____________________ | Payee's Name: ____________________ |
| Signature: ____________________ | Signature: ____________________ |

A prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property, when more than 20% of the original amount of the note is prepaid in any 12-month period, is limited to no more than six months' advance interest on any principal prepaid in excess of 20% of the original balance. [See Figure 1 §2.1]

The prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property may only be charged in the first five years of the note. **After five years**, the note can be prepaid without a penalty. [Calif. Civil Code §2954.9(b)]

On a loan arranged by a mortgage loan broker and originated by a private lender which is secured by an owner-occupied, single family residence (SFR), up to 20% of the remaining principal balance may be prepaid in any 12-month period without penalty.

The penalty on broker-arranged loans for any prepaid principal exceeding 20% of the remaining balance is limited to six months' advance interest on the excess principal reduction. However, the penalty may be imposed for up to **seven years** after origination of the loan. [Calif. Business and Professions §10242.6; see Figure 1 §2.2]

On notes secured by other than owner-occupied, one-to-four residential units, the noteholder may charge a prepayment penalty limited in amount and time only by reasonableness.

However, if the noteholder intends to collect a prepayment penalty should he ever call the note under a due-on clause in his trust deed (excluding one-to-four unit residential property), the payor must sign or initial a separate prepayment penalty provision which includes a waiver of his right to prepay without a penalty. [CC §2954.10; see Figure 1 §2.3]

**Figure 3**

*Excerpt from* ***first tuesday*** *Form 418-2 —*
*Prepayment of Prinicipal Provisions*

2.4 *Discount for early payoff provision*:

☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a ______% discount, plus accrued interest and future advances, for the period expiring _____________, 20______.

**Figure 4**

*Excerpt from* ***first tuesday*** *Form 418-5 —*
*Note Enforcement Provisions*

2.1 **Guarantee provision**

☐ The Note is guaranteed by ___________________________________, under a Guarantee Agreement dated _____________, 20______, at _______________________________, California. [See **ft** Form 439]

2.2 **Exculpatory provision**

☐ Enforcement of the Note and Trust Deed is subject to the purchase money anti-deficiency provisions of Code of Civil Procedure §580b.

2.3 **Governing law provision**

☐ This Note is governed by California law.

**Late charges and grace periods**

A late charge provision in a trust deed note usually permits collection of an additional one-time fee or interest accrual on the amount of the delinquent payment of principal and interest.

On notes secured by real estate, except a note secured by an owner-occupied single family residence (SFR) or a loan made or arranged by a mortgage loan broker, the **late charge** assessed for the delinquent payment of an installment must be an amount *reasonably related to:*

- the private lender's or carryback seller's actual out-of-pocket losses incurred in preforeclosure collection efforts; or
- the value of the lost use of the delinquent funds. [CC §1671; see Figure 2 §2.3]

A typical late charge provision takes the form of a flat fee or a percentage of the monthly installment or note balance.

However, a late charge provision in a note specifying an increased interest rate on the **entire remaining principal** on default of any monthly installment, called a *default interest rate*, is unenforceable since it is a penalty provision in disguise.

A penalty provision is **void** if it fails to reasonably estimate compensation for the lender's losses caused by the default. The rate of interest on a default can only be applied to the delinquent principal and interest payment since only an installment is delinquent, not the entire principal balance of the note. [**Walker** v. **Countrywide Home Loans, Inc.** (2002) 98 CA4th 1158]

The amount of a late charge on any note secured by an **owner-occupied SFR** is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5. [CC §2954.4; see Figure 2 §2.1]

For loans made or arranged by a real estate broker and secured by **any type of real estate**, a late charge on delinquent monthly payments is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5. [Bus & P C §10242.5(a); see Figure 2 §2.2]

**A default on the balloon payment**

When a broker-arranged loan contains a due date for a balloon payment, a late charge may be assessed if the balloon payment is not received within ten days after the due date.

The maximum enforceable late charge assessed on the a delinquency of a balloon payment on a **broker-arranged** loan, which can be further assessed for each following month the balloon payment remains unpaid, is an amount equal to the maximum late charge imposed on the **largest installment payment scheduled** in the note. [Bus & P C §10242.5(c); see Figure 2 §2.4]

On all installment sales, except for an owner-occupied SFR, an **increased interest rate** on the remaining principal, triggered by a delinquency of the final/balloon payment, is an acceptable late charge provision. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701; see Figure 2 §2.5]

However, as a late charge, any increase in the interest rate triggered by a delinquency is still controlled by reasonableness.

For carryback SFR notes and broker-arranged loans, an installment is not late if paid within ten days after the installment is due, called a *statutory grace period*. [CC §2954.4; Bus & P C §10242.5]

Also, on an SFR note or broker-arranged loan, the private lender or carryback seller cannot charge more than one late charge per delinquent monthly installment payment — no matter how long the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b)]

**Compounding on default**

A *compounding-on-default interest provision* is triggered by a delinquency in a payment. Compounding causes interest to accrue on the interest contained in the delinquent installment at the note rate until the delinquent payment and compounded interest are paid. [See Figure 2 §2.6]

Compounding interest provisions are used in lieu of flat fee or percentage late charge provisions.

Under a compounding interest provision, the reinstatement amount includes the delinquent principal and interest payment plus the additional compounded interest which has accrued.

A compounding interest provision is a type of **late charge** since it penalizes the borrower and is triggered by a delinquency in a payment, although no case or statute defines it as such.

As a late charge, the limitations on amounts and grace periods for late charges apply to the enforcement of provisions calling for compounding on default.

**Balloon payment notice**

A balloon payment is a final lump sum payment of remaining unpaid principal, which is due on an earlier date than had the periodic payment schedule continued until the principal was fully amortized.

A **balloon payment note** secured by an owner-occupied, one-to-four unit residential property is a note which contains provisions for:

- a *final payment* which is more than twice the amount of any of the six regularly scheduled payments preceding the date of the balloon payment; or

- a *call provision*. [CC §§2924i(d), 2957(b), (c)]

A **call provision** gives the private lender or carryback seller the right to demand final payment at any time after a specified period.

All balloon payment notes secured by one-to-four unit residential property must include a reference to the buyer's right to receive a *balloon payment notice* 90 to 150 days before the due date. [CC § 2966; see Form 418-3]

Failure to include the balloon payment notice provision in the note does not invalidate the note, but enforcement of the note's balloon payment provision is continued until the 90-day notice requirements are met. [CC §2966(b)]

**Extension of due date**

A provision may grant the buyer an extension of the due date for a **final/balloon payment** conditioned, for example, on the payment of all scheduled installments without delinquency, or on other consideration, such as a charge or change of terms. [See Form 418-3 §2.2]

An agreement to extend the due date in a carryback note should be considered by a buyer when the term of the note is for a short period of time (less than five years) and the buyer is uncertain about the source and availability of funds for payoff.

**Discount for early payoff**

A buyer's right to pay off the note early is usually documented in the form of an option to buy the note at a discount. [See Form 418-4]

A carryback seller who prefers to be cashed out before the due date set in his trust deed note could include a discount provision to encourage the buyer to pay off the note within a lesser time period than the due date period. The provision can be structured to give the buyer several months to exercise the option to pay off the debt at a discount on the face value (or remaining balance) of the note.

By exercising the option, the buyer who executed the note may either buy the note and trust deed from the seller by an assignment or request a reconveyance of the trust deed.

**Right of first refusal**

When the noteholder decides to sell the note, a *right of first refusal* provision contained in the note or a separate agreement allows the owner of the secured real estate to purchase or pay off the note. [See Form 418-4]

If the noteholder decides to sell the trust deed note, the buyer is notified of the amount necessary for payoff.

The **payoff amount** will be the sales price of the note and is set based on the lesser of either:

- the noteholder's listing of the trust deed note for sale, or their offer to sell the note; or
- an offer from an investor to purchase the note, which, if accepted, must be accepted contingent on the buyer's exercise of the right to pay off the note.

The buyer, to exercise the right of first refusal, must then match the price.

However, when granting the right of first refusal, the noteholder must be careful not to set the price in advance by stating a price in the right of first refusal provision.

If the payoff amount is set by a prior agreement, the seller is bound by the amount, even if market conditions allow for a higher value when the seller decides to sell the note.

**Guarantor**

To protect the private lender or carryback seller from loss due to a default on his trust deed note, the private lender or seller may require a third party with sufficient assets to become *liable on call* for all amounts due under the note and trust deed, called a *put option*.

By guaranteeing the note, a guarantor literally agrees to buy the note from the private lender or carryback seller, a legal process called *subrogation* or *equitable assignment*.

The private lender or carryback seller has three types of third party assurances:

- a co-owner's signature on the note and trust deed;
- a co-signer's signature on the note only; or
- a personal guarantee of the note by one other than the buyer.

When a third party signs the note, the third party becomes **liable for repayment** of the note, subject to anti-deficiency rules protecting co-owners on any type of foreclosures and co-signers on trustee's foreclosures. [California Code of Civil Procedure §580b]

However, if a third party agrees to guarantee the note and trust deed, a **guarantee agreement** is signed by the third party and is **enforceable separately** from the note and trust deed.

If the note is guaranteed, a provision may be included in the note to reference the separate guarantee agreement. [See Figure 4 §2.1]

By referencing the separate guarantee agreement in the note, everyone is on notice of the additional security for the note provided by the guarantee.

**Exculpatory clause**

An *exculpatory clause* in a note converts a lender's recourse paper into nonrecourse paper.

When the note carried back by a seller is either separately or additionally secured by property other than the property sold, the note becomes recourse paper. Thus, the buyer needs to consider negotiating for inclusion of an exculpatory clause as a provision in the note. [See Figure 4 §2.2]

When an exculpatory clause is included in a cross-collateralized note (two or more properties are described in the trust deed as the security), neither the private lender nor the carryback seller can obtain a money judgment for any deficiency on a judicial foreclosure of the secured property. Thus, the note has agreed-to anti-deficiency protection.

### Governing law

A private lender or carryback seller involved in negotiating a carryback sale with an out-of-state buyer must include a *choice-of-law* provision to assure judgments arising from disputes on the note will be based on California law.

### Property taxes and insurance premiums

An impound account provision is included in the trust deed by way of an addendum. With an impound account, the security for the debt will remain unimpaired by defaults in taxes, assessments, and insurance premiums should the beneficiaries have to initiate foreclosure to enforce collection of the principal debt. [See **first tuesday** Form 455]

The owner's payment of taxes and insurance premiums before they become delinquent is required by the trust deed, even if the trust deed does not include an impound account provision to accumulate funds in advance for the payment of taxes and insurance premiums.

By establishing an impound account, the owner must monthly prepay a prorata share of taxes and insurance premiums to the trust deed beneficiary, whether the beneficiary is a lender or a carryback seller. Impounds are amounts paid in addition to the regular monthly installment of principal and interest due on the note.

The beneficiary receives the taxes and insurance payments and holds them in an impound account, also called an *escrow account*. The accumulated funds are disbursed by the beneficiary when the taxes or premiums become due.

A lender or carryback seller secured by a trust deed on an **owner-occupied** single family residence (SFR) can only require the owner or buyer to agree to an impound account if:

- the combined principal amount of two or more notes secured by the real estate is 80% or more of the real estate's appraised value;
- the note amount is 90% or more of the appraised value of the real estate;
- the owner becomes delinquent on two consecutive property tax installments;
- the impound account is required by a state or federal agency; or

**Figure 5**

**Impound account deposit**

(Determines largest shortfall for disbursements)

| | pmt | disb | bal |
|---|---|---|---|
| June | 0 | 0 | 0 |
| July | $417 | 0 | $417 |
| August | $417 | 0 | $833 |
| September | $417 | 0 | $1,250 |
| October | $417 | 0 | $1,667 |
| November | $417 | 0 | $2,083 |
| December | $417 | $4,300 | -$1,800 |
| January | $417 | 0 | -$1,383 |
| February | $417 | 0 | -$967 |
| March | $417 | 0 | -$550 |
| April | $417 | 0 | -$133 |
| May | $417 | $700 | -$417 |
| June | $417 | 0 | $0 |

**Figure 6**

**Adjusted balances**

(Lowest initial impound balance)

| | pmt | disb | bal |
|---|---|---|---|
| June | 0 | 0 | $1,800 |
| July | $417 | 0 | $2,217 |
| August | $417 | 0 | $2,633 |
| September | $417 | 0 | $3,050 |
| October | $417 | 0 | $3,467 |
| November | $417 | 0 | $3,883 |
| December | $417 | $4,300 | $0 |
| January | $417 | 0 | $417 |
| February | $417 | 0 | $833 |
| March | $417 | 0 | $1,250 |
| April | $417 | 0 | $1,667 |
| May | $417 | $700 | $1,383 |
| June | $417 | 0 | $1,800 |

- the loan is made, guaranteed, or insured by a state or federal governmental lender or insurer. [CC §2954(a)]

For SFR situations where a beneficiary cannot require an impound account, the owner of the SFR may **agree** to an impound account. However, prior to the execution of the loan documents, carryback note and trust deed, the beneficiary must give the owner a written **impound account disclosure statement** notifying the owner:

- the impound account cannot be required as a condition to the funding of the loan or carrying paper; and

- whether or not interest will be paid on the funds held in the impound account. [CC §2954(a)]

**Figure 7**

**Initial deposit for impound account**

(Advance deposit to build reserves)

| | pmt | disb | bal |
|---|---|---|---|
| May (deposit) | $2,633 | 0 | $2,633 |
| June | 0 | 0 | $2,633 |
| July | $417 | 0 | $3,050 |
| August | $417 | 0 | $3,466 |
| September | $417 | 0 | $3,883 |
| October | $417 | 0 | $4,300 |
| November | $417 | 0 | $4,716 |
| December | $417 | $4,300 | $833 |
| January | $417 | 0 | $1,250 |
| February | $417 | 0 | $1,666 |
| March | $417 | 0 | $2,083 |
| April | $417 | 0 | $2,500 |
| May | $417 | $700 | $2,216 |
| June | $417 | 0 | $2,633 |

### Impound payment requirements

When provisions in a trust deed encumbering any type of real estate establish an impound account calling for taxes and insurance premiums, the **beneficiary must**:

- set the amount of the **initial deposit** and **monthly payments** to be made into the impound account — the amounts must be reasonably necessary to accumulate sufficient funds to pay the property taxes, assessments and insurance premiums when due; and

- from the funds received, pay property taxes before they are delinquent and insurance policy premiums before they are canceled. [CC §2954.1]

The **initial deposit** in an impound account on a note secured by any type of real estate, whether a loan or a carryback, is capped at:

- the total dollar amount of payments for taxes and insurance premiums prorated for the period running from the date their payment was last due to the date of the first installment due on the note; plus

- a reserve of one sixth of the total dollar amount of payments due for the period running from the date the last payments for property taxes and insurance premiums were due to the date of the first payment under the note.

Further, the **monthly impound payments** for an impound account on a note secured by any type of real estate are capped at:

- one twelfth of the estimated annual payments for taxes and insurance; plus

- any deficiency in the reserve of one sixth of the total annual payments for property taxes and insurance premiums. [CC §2954.1(a); 12 United States Code §2609]

*Editor's note — The Real Estate Settlement Procedures Act (RESPA) has established regulations for impound accounts. [12 USC §2605(g); 24 Code of Federal Regulations §3500.17]*

*All federally related loans must comply with the requirements. A federally related loan subject to RESPA is a loan secured by a trust deed on one-to-four unit residential property or a mobilehome.*

*A lender making a federally related loan is subject to RESPA regulations if the lender:*

- *annually invests or originates loans retained in the lender's portfolio totaling over $1,000,000;*

- *is a federally insured bank or thrift;*

- *is making loans eligible for purchase in the secondary mortgage market by the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) or the Government National Mortgage Association (Ginnie Mae); or*

- *is making loans insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). [24 CFR §3500.2(a)(3)]*

*While a real estate broker making or arranging federally related loans is subject to RESPA requirements, a* ***carryback seller*** *is not. However, the regulations do serve as one method for handling impounds.*

**Annual accounting by the seller**

A seller carrying back a note and trust deed on one-to-four unit residential property with an impound provision must provide the buyer with an **annual impound accounting** within 60 days after the end of the calendar year. [CC §2954.2]

The annual impound accounting must itemize:

- the amount received and applied to interest and principal;
- money received and disbursed from the impound account for the payment of property taxes, bond assessments and insurance premiums; and
- any late charges. [CC §2954.2(a)]

**Interest accruing on impound accounts**

When the property securing a loan is a one-to-four unit residential property and the loan has an impound account, the financial institution holding the loan must pay 2% annual **simple interest** on any balance in the impound account. A fee cannot be charged for maintaining the impound account if it would cause the interest received on the account to fall below 2%. [CC §2954.8(b)]

A financial institution includes a bank, savings and loan association (S&L), credit union, or any other person or organization making loans secured by one-to-four unit residential property. [CC §2954.8(c)]

However, **carryback sellers** are not financial institutions, and are not required to pay interest on impound accounts established in a carryback trust deed.

**Impounds and trust funds**

Consider a carryback seller on any type of real estate whose buyer agrees to an impound account. The seller receives the monthly payments of principal, interest and impounds for the payment of property taxes, bond assessments and insurance premiums.

Is the seller required to maintain a separate bank account for the impounds?

No! Unlike trust funds, a carryback seller or lender may commingle the owner's impounds with its **general funds** and retain all the benefits from these funds.

However, the impound funds must remain in the state of California. If invested, the funds can only be invested with residents of the state or partnerships and corporations which are engaged in business in the state. [CC §2955]

**Calculating impound amounts**

One method used by lenders and carryback sellers for calculating an impound account balance is found in Real Estate Settlement Procedures Act (RESPA) regulations. [24 CFR §3500 Appendix E]

Consider the sale of any type of real estate in which the seller will carry back a note and trust deed. The carryback seller will also maintain an impound account.

The buyer will incur:

- annual property taxes of $4,300, due on December 10; and
- an annual hazard insurance premium of $700, due on May 15.

Escrow will close on May 15 and the first payment is due to the carryback seller on the first of July.

The monthly impound balances are calculated to set the **initial deposit** necessary to avoid negative impound balances during any month due to disbursements.

The initial deposit for the impound account and the monthly impound payments are calculated based on whether:

- each disbursement by the seller from the impound account will be timely made; and
- the payments into the impound account by the buyer are one twelfth of the total annual property taxes and insurance premiums due. [See Figure 5]

From the balance in the impound calculated monthly in Figure 5, the lowest monthly balance — a deficiency — is to be **initially deposited** by the owner to keep the impound account balance from dropping below zero during any one month. [See Figure 6]

In our example, December has the lowest monthly balance of $1,800. [See Figure 5]

Also, a permissible **reserve balance** equal to one sixth of the total annual disbursements is added to the impound account balances.

In our example, the reserve is $833 — one sixth of $5000 in taxes and insurance premiums.

Thus, the initial deposit in the impound account is the $1,800 deficiency (Figure 5) and the one sixth reserve, which equals $2,633 (Figure 7). During the first year of loan payments, the buyer's monthly payment into the impound account is $417.

# Chapter 24 — Due-on-sale regulations

*This chapter clarifies the events which trigger a lender's due-on clause and analyzes the adverse socio-economic effects of due-on regulations on the real estate resale and equity loan markets.*

### *Chapter 24 Outline*



### *Chapter 24 Terms*

| | |
|---|---|
| *Acceleration* | *Inter vivos trust* |
| *Advisor* | *Joint tenant* |
| *Assignment* | *Modification* |
| *Assumption* | *Novation* |
| *Debilitating effect* | *Option money* |
| *Deregulation* | *Pre-emption* |
| *Due-on clause* | *Property settlement* |
| *Due-on-sale* | *Retroactive interest differential (RID)* |
| *Due-on waiver* | *The Garn Act* |
| *Equitable owner* | *Waiver agreement* |
| *Equity loan* | *Waiver by consent* |

## Rising rates bring lender interference

During the good times of upward sales volume, expanding mortgage origination and increasing absorption rates for available rented space, the marketplace functions at full throttle—a virtuous cycle. Social benefits of lending abound.

Every sales activity feeds on every other sales activity. No one seems to care about the excuses and inherent inefficiencies buried in the process.

Responsibility for all this frenzy lies solely with the gatekeepers to entry into real estate ownership, and relocation—the brokers and lenders. All other parties to a real estate transaction, being merely affiliated, provide closing services once the broker has located a buyer and the lender qualifies that buyer (and the property) for a purchase-assist loan. Singularly, these two events by these two guardians of real estate are the nucleus of a sale, and all else follows as support services.

During the good times of rising prosperity for all, buyers will put up with the onerous threshold of entry procedures maintained by these gatekeepers. In the rush to do deals, all the numerous steps to ownership seem to be justified, or are simply overlooked as necessary tedium to get in on the act.

However, when, as always it must, the cause of a recession - short-term interest rates rise to outrun inflation - dampens enthusiasm (1989, 2000, 2005). The restrictions on entry posted by the brokers and lenders, burdensome in the first place, are actually tightened to discourage the able and ready buyers who then become unwilling to put up with both the hassles of entry or relocating and the regime of higher rates and increased credit standards: A vicious cycle which takes years to unwind after it bottoms.

Enter *due-on-sale* restrictions (and efforts to get around brokers). As a result, socio-economics decline.

One of the burdens on the mobility of title necessary to sell real estate which restricts the ease with which a buyer and seller can make a deal is the *due-on clause* you will find buried within the copy of all trust deeds held by lenders. During boom years, buyers can easily qualify for a new loans and sellers are relatively unconcerned about the size of the prepayment penalty on their mortgages that the due-on clause is not an issue.

However, as the boom turns to bust and buyers want to buy property, the most effective financing arrangement is to take over the seller's loan. However, the lender as the gatekeeper generally says no to any type of loan takeover or assumption—"I want my repayment penalty and I can re-lend the money at higher current rates." Thus, what was not a burden and not a factor inhibiting deals made during the boom becomes a noose about the seller's neck tying him to his property without a way through the MLS to get out from under the loan—or the property.

### Attempts to circumvent the restraint

A parcel of real estate which is listed for sale is security for a loan under a first trust deed lien containing a **due-on clause**. The seller's agent locates a buyer for the property.

The purchase agreement negotiated by the seller's agent calls for closing to be contingent on the buyer entering into an *assumption agreement* with the first trust deed lender allowing the buyer to take over the loan on the property. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's down payment.

The buyer is advised the senior lender may:

- refuse to allow the loan to be assumed, forcing the buyer to arrange new financing suitable to acquire the property; or

- require a modification of the loan at a less favorable rate than the note rate on the loan and demand a large assumption fee.

Before contacting the lender to process an assumption, the buyer suggests the sale of the property be structured as a lease-option in an attempt to avoid due-on enforcement by the lender.

The buyer and seller discuss entering into a two-year lease agreement with an option to extend the lease for two years at an increased monthly payment. The buyer will be granted an option to purchase for the life of the lease.

The down payment will be restated as *option money*. The **option money** will apply to the purchase price of the property, as will a portion of each monthly payment, called *rent*.

Meanwhile, the seller will continue making payments on the trust deed loan. When the buyer exercises his purchase option, the loan will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the lender?

No! Any lease agreement which contains an option to purchase triggers due-on enforcement by the lender on discovery. [12 Code of Federal Regulations §591.2(b)]

**Lender interference authorized by federal mortgage law**

Generally, all lenders and carryback sellers are allowed to enforce their due-on sale clauses in trust deeds on nearly all transfers of an interest in any type of real estate. [12 United States Code §1701j-3, Garn-St. Germain Depository Institutions Act of 1982 (Garn)]

Thus, federal mortgage law deprives Californians (and residents of numerous other states) of their state law right to convey real estate subject to trust deed liens without the lender interfering with the transfer of ownership, unless the lender can show the buyer lacks creditworthiness, a federal legislative process called *pre-emption*.

The occurrence of an event which triggers due-on enforcement automatically allows the lender to:

- **call the loan**, demanding the full amount remaining due be paid immediately, also known as *acceleration*; or

- **recast the loan**, requiring a modification of the loan's terms as a condition for the lender's consent to a transfer, called a *waiver by consent*.

# "It has recently come to our attention . . ."

## Trust deed called or recast at lender's option

### Events triggering the due-on clause

**Sale:**

- transfer of legal title (grant or quitclaim deed);
- land sales contract or holding escrow;
- court-ordered conveyance; or
- death.

**Lease:**

- lease for more than three years; or
- lease with an option to buy.

**Further encumbrance**:

- creation or refinance of a junior lien; or
- foreclosure by junior lienholder.

## Transfers not triggering due-on enforcement

### (owner-occupied, four-or-less residential)

- creation of junior lien where owner continues to occupy;
- transfer to spouse or child who occupies;
- transfer into inter vivos trust (owner obtains lender's consent and continues to occupy);
- death of a joint tenant; or
- transfer on death to a relative who occupies.

The *Garn Act* encourages lenders to allow buyers to assume real estate loans at existing rates, but provides lenders no incentives for doing so. The congressional intent in passing the *Garn Act* was to **pre-empt state law restrictions** of due-on enforcement, allowing the lenders to increase their profits, a process called *deregulation*.

However, the enforcement of the due-on clause by lenders was not intended to occur at the expense of permitting **excessive lender interference** with real estate transactions, whether they are sales, leases or further encumbrances. [12 USC §1701j-3(b)(3)]

Yet, when the Federal Home Loan Bank Board (now the Office of Thrift Supervision (OTS)) issued **due-on regulations** to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights.

The OTS regulations allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence exceptions. No encouragement or guidelines were established in the regulations as proffered by congress for lenders to consent to loan assumptions or to limit interference in commonplace transactions.

Since lenders often disregard the law in their trust deed lending and enforcement practices, it is hard to imagine why they would comply with a mere congressional request, a "moral risk" created by congressional reaction to lender misconduct. In the absence of any regulatory obligation, lenders use their due-on clauses to maximize their financial advantage over owners by calling or recasting loans on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market by adjusting the rate of interest.

**Economic recessions and recoveries**

In times of stable or falling interest rates, lenders, when requested, usually permit assumptions of loans at the existing note rate, unless a prepayment penalty clause exists. Lenders have no financial incentive to recast loans, or call and re-lend the funds at a lower rate when interest rates are dropping in the marketplace.

However, in times of steadily rising rates, lenders seize any event triggering the due-on clause as an opportunity to increase the interest yield on their portfolio. Once the due-on clause is triggered, the lender requires the loan be recast at current market rates as a condition for allowing an assumption, lease or further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on trust deeds becomes increasingly difficult to transfer as interest rates rise, contributing to the "imprisoning" of an owner in his own home as he is unable to relocate. Lender due-on interference is virtually guaranteed since the interference results in an increase in the lender's portfolio yield which permits them to remain solvent, if not the owner.

However, the *inhibiting effect* on buyers during recessions when buyers are required to assume existing financing at higher interest rates has an adverse economic effect on real estate sales, as well as the availability of private junior financing and long-term leasing. Ultimately, as rates and lender interference rise, many buyers, equity lenders and long-term tenants are driven out of the market, which further depresses property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, leaving owners with no (read: negative) equity in the property. It is a vicious cycle which evolves into a dramatic increase in loan foreclosures, the antithesis of the profit motive for automatic lender enforcement of the due-on clause.

Due-on interference was an obscure issue during the 25-year period (1982 through 2007) after *Garn* became law. During this period, fixed mortgage rates declined from 15% to 5% as managed by the Federal Reserve Bank, the earnings of buyers increased (but not as fast as inflation was rising), inflation dropped, and mortgage money became more plentiful. All that was reversed commencing in 2007.

**Due-on-sale**

Due-on clauses are most commonly known as *due-on-sale* clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the lender's due-on clause is a sale of property which is subject to the lender's trust deed lien.

The due-on clause is triggered not only by a transfer using and recording a standard grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, whether or not it is recorded. Examples include a land sales contract, lease-option sale, or other alternative carryback devices, such as an all-inclusive trust deed (AITD).

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed. The seller on a contract (for deed) retains title as security for the carryback debt owed by the buyer rather than use a trust deed lien to evidence his security interest. However, the buyer becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession is transferred, triggering the due-on clause in any existing trust deed (and reassessment). [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

**Due-on-lease**

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term when coupled with the grant of an option to purchase to the tenant. [12 CFR §591.2(b)]

For example, an owner with a short-term interim construction loan for nonresidential rental property obtains a conditional commitment from a long-term lender for take-out financing to pay off the construction loan. Funding of the take-out loan is conditioned on the property being 80% occupied by tenants with an initial lease term of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with a lease term of five years or more. The lender funds the loan. The loan is secured by a trust deed lien on the

## Due-on enforcement and prepayment penalties

Consider an owner of real estate which is encumbered by a trust deed securing a note containing a **prepayment penalty clause**. The owner sells the property, triggering the due-on clause in the lender's trust deed.

The lender, unwilling to consent to an assumption by the buyer, calls the loan due. The buyer obtains a new purchase-assist loan from a different lender, enabling the buyer to pay off the existing loan.

The lender informs the buyer he will have to pay a prepayment penalty due to his early payoff of the loan.

The buyer claims he cannot be charged a prepayment penalty since the early payoff was not the buyer's choice, but was a result of the lender exercising his right to call the loan due-on-sale. Thus, the note is due by its terms.

Can a lender charge a prepayment penalty after calling a loan due?

Yes! The prepayment penalty clause in most trust deeds allows the lender to charge a penalty if the loan is **voluntarily or involuntarily** paid off before the due date**.**

Before 1983, a lender's prepayment penalty clause frequently called for a penalty only if the property owner voluntarily paid off the loan before the due date. Thus, the lender was barred from enforcing prepayment penalties in an *involuntary payoff*, after calling a loan due under the due-on clause. [**Tan** v. **California Federal Savings and Loan Association** (1983) 140 CA3d 800]

The lenders' response to the *Tan* decision was to reword their prepayment penalty clauses to impose a penalty for any prepayment of the loan, whether voluntary or involuntary.

However, when a loan is secured by a trust deed on owner-occupied, one-to-four unit residential property, federal regulations bar the lender from imposing a prepayment penalty when accelerating the loan under its due-on clause. [12 CFR §591.5(b)(2)]

property, which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the lender's trust deed. The long-term leases were entered into before the loan funded and the trust deed recorded.

However, after obtaining the loan, the owner continues to lease out space in his property for five year terms. Later, after interest rates rise, a representative of the lender (a prior loan officer) visits the property and "discovers" new tenants. On inquiry, the officer learns that some of the tenants entered into leases, or had their leases extended for periods greater than three years, after the loan was recorded.

The lender sends the owner a letter informing him it is calling the loan due since the owner has entered into lease agreements with terms over three years without their prior consent.

The owner claims the lender cannot call the loan since long-term leases were required by the lender as a condition for funding the loan.

Can the lender call the loan due or demand a recast of its terms?

Yes! By requiring leases with terms over three years as a condition for funding the loan, the lender did not waive its right to call or recast the loan under its due-on clause should a lease with a term over three years be entered into after the loan was originated.

However, an **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless the lease is modified to extend the term beyond three years, or a purchase option is granted to the tenant.

For example, consider an owner of real estate who enters into a lease with an initial term of 10 years. Later, the owner takes out a loan secured by a trust deed containing a due-on clause. After the trust deed is recorded, the tenant assigns the lease with the owner's approval, as provided in the lease agreement (which has priority to the lender's trust deed).

However, the lender's due-on clause is not triggered by the lease assignment. The trust deed is attached as a lien only on the owner's fee interest, not the leasehold interest the owner previously conveyed to the tenant. The fee owner whose interest is encumbered by the loan transferred nothing. The assignment of a leasehold by a tenant is not a transfer of any interest in the fee encumbered by the trust deed.

However, consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a novation of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. Since the novations included a leasing period of over three years, the lender may call the loan. [**Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424]

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability by the landlord, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation. Accordingly, a lease **novation** triggers the due-on clause — if the lease has a remaining term of over three years or includes an option to purchase.

## Due-on-further encumbrance

An owner-occupant of a single family residence (SFR) subject to a first trust deed applies for an **equity loan** to be secured by a second trust deed on his property. The first trust deed contains a due-on clause.

The loan broker tells the owner he is concerned about due-on enforcement by the senior lender, since the execution of a second trust deed will convey a security interest in the property by encumbering it with a lien. On inquiry, the owner informs the broker he will continue to occupy the property as his residence.

The broker correctly assures the owner the second trust deed encumbrance will not trigger the senior lender's due-on clause, as long as the owner continues to occupy the residence. Due-on enforcement based on a further encumbrance of an owner- occupied, one-to-four unit residential property is not permitted. Equity loans are a source of consumer funds which stimulate the economy. [12 CFR §591.5(b)(1)(i)]

However, on real estate other than an owner- occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing lender's waiver of its due-on clause triggers the due-on clause, giving the lender the right to call or recast the loan.

Thus, junior financing without a waiver of the senior lender's due-on clause becomes a risky enterprise for trust deed investors in times of rising interest rates. Increasing market rates give trust deed lenders a powerful incentive to call loans on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

For example, a private lender accepting a junior trust deed position on a type of property other than an owner-occupied, one-to-four unit residence without first obtaining a **due-on waiver** from the senior lender risks having the economic value of his position in title:

- **reduced** by an increase in the interest rate on the first; or

- **wiped out** by the first's foreclosure, should the first exercise its due-on rights based on the further encumbrance and not be paid in full. [**La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864]

Owners are driven to look elsewhere for funds when the existing lender does not grant a due-on waiver. Thus an owner is forced to unnecessarily refinance existing encumbrances in order to generate cash from their equity in the property, a more expensive process due to prepayment penalties and increased rates than had they obtained an equity loan.

Now consider a seller who carries back a second trust deed on the sale of property without the consent of the holder of the first trust deed which contains a due-on clause.

The first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and modifies the note by shortening the due date.

The carryback seller claims his second trust deed now has priority over the first trust deed since the modification of the first trust deed note substantially impairs his security by increasing the potential for default on his trust deed.

Here, the modification of the first trust deed note without the consent of the junior carryback seller does not result in a change in trust deed priorities since the existence of the second trust deed note is in violation of the due-on clause in the first trust deed.

When the secured property is sold and the seller accepts a second trust deed without receiving the lender's prior written consent, the due-on clause has been breached under federal mortgage

law. Thus, no duty is imposed on the first trust deed lender to avoid further subordinating the interest of the holder of the unconsented-to junior lien by recasting the first trust deed note. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

**Due-on-foreclosure**

A parcel of real estate is subject to a first trust deed lien and second trust deed lien to which the first consented. The property owner defaults on the first trust deed. The junior trust deed holder reinstates the first trust deed and forecloses on the second, acquiring the property at the trustee's sale. At all times the second trust deed holder kept the first trust deed current.

The senior lender informs the junior lender, who now owns the property, that it is calling its loan due, based on the transfer of the property by trustee's deed.

Can the senior lender call its loan due based on the completion of foreclosure by the second trust deed lender?

Yes! A senior lender may call a loan due on completion of the **foreclosure sale** by a junior lender or carryback seller on any type of real estate. A *trustee's deed* on foreclosure is considered a voluntary transfer by the owner, since the power of sale authority in the junior trust deed was agreed to by the owner of the real estate.

However, the due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, but also by any involuntary foreclosure, such as a tax lien sale. [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien, whether the transfer be voluntary or involuntary. [12 CFR §591.2(b)]

The risk of a senior lender enforcing its due-on clause on a trustee's sale by the junior lender has a **debilitating effect** on the availability of junior trust deed loans and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt should they be forced to foreclose on the real estate. [**Pas** v. **Hill** (1978) 87 CA3d 521]

**Due-on-death and exceptions**

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner even if title was vested in a revocable inter vivos trust. However, as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause, on the condition the relative becomes an occupant of the property. [12 CFR §591.5(b)(1)(v)(A)]

Also, where two or more people hold title to one-to-four unit residential property as joint tenants, the death of one **joint tenant** does not trigger due-on enforcement as long as the surviving joint tenant currently occupies the property. [12 CFR §591.5(b)(1)(iii)]

In all other transfers, the death of a vested owner, joint tenant or other co-owner will trigger the lender's due-on clause.

Thus, due-on enforcement is **triggered on death** by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which is not currently occupied by any surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and
- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

**Divorce and inter-family transfers**

A married couple occupies a residence which is vested in the name of the husband and owned as his separate property. The residence is subject to a trust deed containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the **property settlement** to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the lender?

No! Federal due-on regulations bar due-on enforcement on transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property. [12 CFR §591.5(b)(1)(v)(C)]

However, if the acquiring spouse chooses to lease the residential property to tenants for any length of time rather than occupy it, the lender can call or recast its loan.

Also, the due-on clause is not triggered by an owner's transfer of his one-to-four unit residential property to a **spouse or child** who occupies the property. [12 CFR §591.5(b)(1)(v)(B)]

This inter-family transfer exception for four-or-less residential property applies only to transfers from an owner to a spouse or child. For instance, any transfer from a child to a parent to provide housing for the parent triggers due-on enforcement.

Finally, consider an owner-occupant of one-to-four unit residential property who transfers the property into an *inter vivos trust*, naming himself as beneficiary. The owner continues to occupy the property after transferring title into the trust, commonly known as a living trust.

The owner **notifies the lender** he will be transferring title into the trust vesting. The owner agrees to give the lender notice of any later transfer of his beneficial interest in the trust or change in occupancy of the property as requested by the lender.

Would this transfer into a living trust trigger the due-on clause in a trust deed encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust. [12 CFR §591.5(b)(1)(vi)]

To meet regulations, the owner must provide means **acceptable to the lender** by which the lender will be given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the lender's approval of the notice provision, the lender may call the loan due.

The notification provision requires the owner to first obtain the lender's consent before transferring the property into a trust vesting.

Also, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the lender can call or recast the loan.

**Waiver by negotiation and by conduct**

Under federal regulations, lenders have the power to dictate the fate of financing in most real estate transactions, since most real estate is encumbered by adhesion trust deeds containing due-on clauses.

However, an owner wishing to enter into a transaction to sell, lease or further encumber his real estate without lender interference must first negotiate a **limitation or waiver** of the lender's due-on rights.

**Waiver agreements** are basically trade-offs. The lender will demand some consideration in return for waiving or agreeing to limit the exercise of its due-on rights in the future, such as increased points on origination, additional security, principal reduction, increased interest and larger payments, a shorter due date or an assumption fee.

For example, a buyer applies for a loan to purchase a residence which he intends to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult for him to resell the property since it will limit the seller's ability to finance the sale of his equity.

Thus, the buyer and the lender negotiate the conditions on which a qualified buyer in a later sale of the property will be able to assume the loan without a call by the lender. In exchange for the lender's limitation of its future due-on rights, the buyer agrees to pay increased points or interest.

Any time a lender recasts a loan as a condition for consenting to a buyer's assumption, it is essentially forcing a *modification agreement* on the buyer. In exchange for agreeing not to call the loan due on a transfer of the property to the buyer, the lender receives consideration, such as increased interest and payments (the modification of the loan) and an assumption fee.

The lender's waiver of its due-on rights under an assumption agreement applies only to the present transfer to the buyer. Unless additionally agreed to, any **later transfer** of an interest in the property will trigger the due-on clause, allowing the lender to call or recast the loan again.

In addition to a waiver (assumption) agreement, waiver of the lender's due-on rights may occur **by conduct** — the lender loses its due-on rights by failing to promptly enforce them.

For example, a buyer purchases real estate subject to a loan secured by a trust deed containing a due-on clause. The lender is informed of the transfer and immediately calls the loan. However, the lender then accepts payments from the buyer for over a year. Finally, the lender seeks to enforce its prior call by refusing further payments and foreclosing.

However, the lender, **by its conduct**, waived the right to enforce its due-on clause. The lender accepted payments from the buyer for over a year after calling the loan on learning of the transfer of the real estate. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

**Broker liability for due-on avoidance**

When the seller intends to transfer ownership of the property to the buyer, the senior lender's due-on clause is triggered regardless of the form used to document the sales transaction.

Of course, the lender can only call the loan when it actually discovers a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term under three years, the lender might not discover any transfer of an interest in the real estate has taken place, which triggered its due-on clause.

If the lender later discovers a change of ownership has taken place, its only remedy against the buyer and seller is to call the loan due, or arrange to recast the loan as a condition for waiving its right to call and allowing an assumption by the buyer. Under the note and trust deed, the lender cannot recover the *retroactive interest differential* (RID) for the period before it discovered the transfer and called the loan.

The only recourse against the buyer or seller is to call the loan and be paid in full or foreclose. [**Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49]

However, **an advisor**, such as a broker or attorney, assisting the buyer or seller to mask the change of ownership from the lender with the primary purpose of avoiding the lender's due-on enforcement, can be held liable for wrongfully interfering with the lender's right to call or recast the loan, an offense called *tortious interference with prospective economic advantage*.

The advisor's liability arises based on the extent to which his actions were **specifically intended** to conceal the transfer and prevent a call by the lender, and on the **foreseeability** the lender would incur losses due to the concealment. [**J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799]

The lender's losses caused by the advisor's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the lender to the date of the transfer.

# Chapter 25 The deficiency in recourse loans

*This chapter presents the formula for setting the deficiency in property value provided by the lender's security under a trust deed, and addresses the unrecoverable loss on an underbid of the fair price at a judicial foreclosure sale.*

***Chapter 25 Outline***

*Set by the value of the secured property*
*The foreclosure-deficiency process*
*The anti-deficiency bar*
*The deficiency judgment*
*Applying the deficiency formula*
*The fair price*

***Chapter 25 Terms***

| | |
|---|---|
| *Deficiency judgment* | *Money judgment* |
| *Fair market value* | *Recourse debt* |
| *Foreclose and exhaust* | *Underbid* |

**Set by the value of the secured property**

An owner of real estate defaults on a loan which is evidenced by a note executed or assumed by the owner. The loan is secured by a trust deed on the property and is a *recourse debt*, not subject to anti-deficiency defenses.

However, the current resale value of the property has declined below the unpaid loan amount due to asset price deflation in the local real estate market.

The lender commences a judicial foreclosure so he can later obtain a money judgment against the owner for any deficiency which may still exist in the property's value at the time of the foreclosure sale.

The property is ordered sold to satisfy the debt. The successful bidder at the judicial foreclosure sale acquires the property for a price less than the amount owed on the debt, called an *underbid*.

A *deficiency judgment* hearing will set the amount by which the property's fair market value fails to cover the total debt, less any liens with priority, on the date of the foreclosure sale.

Both the lender and the owner retain appraisers to establish the fair market value of the property on the date of the sale.

The appraiser for the owner develops a fair market value for the property based on historically normal market conditions. The appraisal is an effort to establish the **intrinsic value of the property** on the date of the foreclosure sale. The appraiser disregards, as transitory, the real estate and financial market conditions which caused a decrease in the property's cash value to the level existing at the time of foreclosure.

In contrast, the appraiser for the lender sets the fair market value of the property based on the cash value of the property in the local real estate market on the date of the foreclosure sale.

After the foreclosure sale and at the hearing setting the property's fair market value, the owner claims the **deficiency amount** to be awarded the lender should be based on the intrinsic value of the property on the date of the foreclosure sale, without any consideration for adverse real estate market conditions which temporarily affect the property's cash value.

The lender claims the amount of the deficiency must be calculated based on the cash value of the property on the date of the foreclosure sale.

Is the lender's cash value appraisal of the property the correct formula for setting a deficiency?

Yes! A **deficiency judgment** is based on a cash value (as though it were unencumbered) of the secured real estate consistent with market conditions at the time of the foreclosure sale, called the *fair market value* of the property. The deficiency judgment is not based on historical, normal or intrinsic values to which the market value of the property may return. [**San Paolo U.S. Holding Company, Inc.** v. **816 South Figueroa Company** (1998) 62 CA4th 1010]

**The foreclosure-deficiency process**

On a default under a trust deed, foreclosure procedures allow the trust deed holder to satisfy the secured debt by selling the real estate interest which is the security interest in the property held by the lender under its trust deed lien.

Foreclosure on the property described in the trust deed is accomplished by one of two procedures:

- a judicial foreclosure, sometimes called a sheriffs sale; or
- a privately arranged, nonjudicial foreclosure, called a trustees sale. [Calif. Code of Civil Procedure §725a]

When the trust deed holder seeks a money judgment on a recourse debt, the person owing the debt – the property owner - can require the trust deed holder — the lender — to first *foreclose and exhaust* — sell all the secured property described in the trust deed. [CCP §726]

To **exhaust** the security and obtain a money judgment, the lender is limited to a judicial foreclosure sale, unless the trust deed has been wiped out by the foreclosure of a prior lien, such as occurs with equity loans on principal residences encumbered by first trust deeds with LTVs exceeding 90% of value which are foreclosed.

For instance, a reversal in the real estate and financial market drives the value of real estate encumbered by a recourse debt below the amount owed on the debt.

On a default, the secured creditor, a lender, chooses to judicially foreclose and recover the difference through a money judgment, called a deficiency.

A judicial foreclosure sale is held. Later, the lender is awarded a money judgment against the borrower who signed or assumed the note secured by the property sold.

The amount of the **money judgment** is the deficiency in the market value of the property on the date of the foreclosure sale resulting from the property's failure to cover all sums then owed on the debt. [CCP §§580a; 726(b)]

In contrast, the trustees foreclosure process allows the secured real estate to be sold at a public auction, under a private agreement between the lienholder and the property owner, called a power of sale provision.

However, a lender who forecloses by a trustee's sale is barred from obtaining a money judgment for any loss on the loan arising out of a deficiency in the value of the secured real estate due to market conditions. [CCP §580d]

### The anti-deficiency bar

*Anti-deficiency* statutes *bar* a deficiency judgment under either the judicial or nonjudicial (trustee's) foreclosure process on:

- any loan which funds the purchase and is secured solely by one-to-four unit residential real estate bought and occupied by the borrower, typically called a purchase-assist home loan;
- any credit extended to a buyer by a seller of any real estate to defer payment of the sales price and secured solely by the real estate sold, also called carryback paper or seller financing. [CCP §580b]; and
- any loan used to refinance debt secured by any one-to-four unit residential real estate, owner occupied or investor owned. [CCP §580e]

The property securing these non-recourse debts is the sole source of recovery for a loss triggered by asset price deflation.

### The deficiency judgment

A deficiency hearing, which must be noticed within three months after the judicial foreclosure sale, will set the amount of the deficiency. [CCP §§580a; 726(b)]

The calculation for a deficiency judgment is based on the difference between:

- the **entire amount of the debt** under the note and trust deed on the date of the judicial foreclosure sale; and the greater of
- the **fair market value of the property** on the date of the foreclosure sale less any amounts owed on liens senior to the trust deed; or
- the **amount paid for the property** at the judicial foreclosure sale. [CCP §580a]

The lender will be awarded a money judgment for the portion of the debt not covered by the fair price of the lender's secured position on title.

The lender and the borrower present evidence at the hearing to establish the property's fair market value.

Evidence includes opinions of appraisers as to the fair market value of the property. [CCP §§580a; 726(b)]

Also, the court may appoint an appraiser, called a probate referee, to advise the court on the value of the property on the date of the sale. [CCP §§580a; 726(b)]

**Applying the deficiency formula**

Consider a lender who judicially forecloses on the security interest it holds in real estate under a trust deed lien. The property is encumbered by unpaid property taxes, liens which the lender does not pay.

At the foreclosure sale, the lender acquires the property, subject to the tax liens, on a credit bid for less than the amount owing on the debt, an underbid. The bid also happens to be less than the fair price of the lender's security interest in the property — the equity in the property over all monetary liens with priority to the lender's trust deed position on title.

At the deficiency hearing, the lender is awarded a money judgment equal to the sums of all amounts owed on the note and trust deed, minus the cash value of the property on the date of the foreclosure sale, plus the unpaid property taxes.

Within one year after the foreclosure sale, the borrower **redeems the property** for the amount bid by the lender, plus interest from the date of the foreclosure sale.

The redemption amount, due to the lender's excessive underbid, is less than the fair value the court set for the lender's security interest, an unrecoverable loss for the lender. The property is still subject to unpaid property taxes.

The borrower now claims the unpaid taxes were improperly added to the deficiency judgment since he will now have to pay them twice:

- once in the deficiency awarded to the lender; and
- again as a lien on the property redeemed.

The lender claims the deficiency is correct since the fair price of its secured position was the property's market value reduced by the tax liens, the only monetary lien with priority to the lender's trust deed.

The amount set as the deficiency is the correct result, although the mathematical approach was incorrect. The secured position held by the lender in the title was subject to property taxes. The unpaid taxes affect the fair price the lender's security interest in the property since the property's tax liens must be deducted from the fair market value of the property to set the fair price of the lender's security interest. [**Luther Burbank Savings and Loan Association** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

*Editor's note — The unpaid taxes were not actually added to the deficiency the lender received.*

*The taxes were actually deducted from the property's cash value by the court's erroneous reversal of all mathematical signs (plus and minus) in the deficiency formula. The end result must be a negative amount to be a deficiency. This trial court's mathematical language only appears to add the unpaid taxes to the deficiency.*

*Here, the correct approach to calculating the deficiency (a negative amount) is to enter the fair market value of the property and subtract both the tax liens (prior monetary liens) and the remaining debt owed the lender. The negative result is the deficiency awarded the lender.*

### The fair price

Again, a deficiency judgment is awarded to a lender based on the unencumbered cash value of the property which is set consistent with current market conditions on the date of the foreclosure sale, called the **fair market value**. [CCP §726]

Clouds on title, such as a junior lien or a lis pendens, wiped out at a foreclosure sale do not affect the property's fair market value. [**Nelson** v. **Orosco** (1981) 117 CA3d 73]

*Editor's note — A federal tax lien with a 120-day right of redemption may reduce the price a buyer would pay for the lender's position in title since the price paid is the amount the IRS would pay to acquire the property.*

However, the price received or the lender's credit bid paid for the property at the foreclosure sale is not considered in setting values. [**Rainer Mortgage** v. **Silverwood**, Ltd. (1985) 163 CA3d 359]

**Fair market value** is set without concern for any negative impact the foreclosure sale may have on the property's value or the price a prudent buyer would pay at the foreclosure sale for the lender's position in title. [San Paolo, supra]

Once the fair market value of the property is determined, the deficiency is the mathematical result of subtracting all prior lien amounts and the amount of the secured debt from the property's fair market value.

If the amount remaining is negative, the lender is awarded a deficiency for the negative amount — the portion of the debt not covered by the fair price of the lender's secured position in the property.

# Chapter 26 Alternative security devices for sellers

*This chapter comments on the use of alternative financing arrangements in lieu of a trust deed to mask a sale of real estate.*

***Chapter 26 Outline***

*Creative financing vs. creative chaos*
*Masking the obvious sale*
*Contract for deed: the land sales contract*
*The contentious contract*
*Due-on-sale and reassessment*
*Contract escrows for delayed recording*
*Unexecuted purchase agreements, extended escrows*
*The lease-option sale*
*Tax aspects*
*Reverse trust deed*
*Filing the IRS 1099-S*

***Chapter 26 Terms***

| | |
|---|---|
| *Alternative documentation* | *Option money* |
| *Contracts for deed* | *Masked security devices* |
| *Equitable owner* | *Price remaining* |
| *Equity remaining* | *Reverse trust deed* |
| *Land sales contract* | *Right of redemption* |
| *Lease option* | *Right to reinstate* |

**Creative financing vs. creative chaos**

The variables for repayment of any debt make up the "creative" aspect of financing, such as the amount of the debt, the interest rate, payment schedule and due date.

Two sets of forms are used in a sale of real estate to document the terms of any carryback financing which will be junior to any existing trust deed liens:

- a note and trust deed, to evidence and secure the balance of the seller's *equity remaining* to be paid after the down payment; or

- an all-inclusive note and trust deed (AITD), to evidence and secure the balance of the *price remaining* to be paid after the down payment.

All other forms used for documenting the terms of carryback financing offer not creative financing, but creative **chaos**, both legal and financial.

Seller financing consists solely of arranging the financing of real estate through the seller's extension of credit on the sales price — an installment sale. Arranging financing does not include the creation of *alternative documentation* to the note and trust deed, sometimes called *masked security devices*.

Creating new forms, by using forms which serve a different purpose than a trust deed (such as a lease-option) or using forms which have outlived their once useful purpose (such as the very obsolete land sales contract), is the primary cause of creative chaos and mistaken expectations.

Documents developed for otherwise legitimate business purposes are occasionally substituted for notes and trust deeds to set up a **smoke screen** in an attempt to avoid due-on enforcement, reassessment for property tax purposes, income tax reporting of profits and the buyer's right of reinstatement or redemption on a default. The purpose is to corrupt the system set up to track conveyancing and, too often, the intended result is actually attained without penalty.

Alternative documentation for a carryback sale includes such instruments as:

- land sales contracts, sometimes called *contracts for deed*;
- long-term escrows with interim occupancy;
- unexecuted or open-ended purchase agreements with interim occupancy, sometimes called lease-purchase agreements;
- lease-option sales contracts; and
- reverse trust deeds coupled with one of the above.

**Masking the obvious sale**

During periods of rising interest rates and decreasing sales, when the frequency of lender due-on enforcement also tends to rise, these alternative financing techniques share a common strategy of creating trappings that **mask the existence** of a sale in order to avoid due-on enforcement. In the masking process, reassessments for an increase in property taxes do not automatically occur.

However, trust deed lenders with due-on clauses are allowed to call or recast a loan on the transfer of any property interest, including a sale, a transfer of any possessory interest, a further encumbrance or a foreclosure of the property, whether recorded or not. [12 Code of Federal Regulations §591.2(b);]

Notable exceptions for the marketplace allow leases of three years or less on any property (without a purchase option), and further encumbrance of owner-occupied, single family residences (SFRs) to escape due-on enforcement.

Since attempts to hide sales from the lender and county assessor usually involve the use of alternative security devices, inherent financial disadvantages exist from the outset of the transaction.

Additionally, by changing the intended use of legitimate documents, the legal rights of the parties to the transaction become different from the rights permitted by the use for which the document was originally drafted, called recharacterization.

With most alternative security arrangements, the new owner/buyer fails to become the owner of record and often fails to exercise the full benefits of ownership, such as interest/depreciation deductions, the right to further encumber the property, property tax exemptions, etc.

Hiding the purchase from the lender generally includes hiding it from everyone, including the Internal Revenue Service (IRS), Franchise Tax Board (FTB), assessors and creditors.

Other disadvantages exist for owner/buyers who use alternative carryback devices in lieu of a note and trust deed, such as the **lack of recording** the documents and the loss of the benefit extended to recorded documents, as well as the lack of title insurance.

If a carryback transaction is to go **unrecorded, unescrowed and uninsured**, at the very least the proper documents should be used — a grant deed, trust deed and note — to avoid compounding the failure to record and obtain a title insurance policy by using chaotic documentation.

**Contract for deed: the land sales contract**

The *land sales contract* was widely used from the late 1960s to the late 1970s as the preferred method for avoiding due-on enforcement by lenders.

The financing arrangement is deceptively simple. A buyer and seller enter into a contract for the sale of property. The buyer takes possession of the property and makes payments according to the terms of the contract. The transaction lacks a formal escrow, title insurance, the numerous disclosures of property conditions and statutorily mandated seller financing disclosures. [See Figure 1]

Title does not formally pass by grant deed until the buyer pays the seller in full.

One might argue the existing lender of record has no cause to call the loan since the record of ownership of the property does not officially change until the contract is fully performed. However, this argument fails since title is not in issue; ownership and its use is.

On entering into a **land sales contract**, an equitable conversion of ownership occurs since the seller from that moment forward is only entitled to receive money, not a return of the property except by foreclosure. Thus, the buyer becomes the *equitable owner* of the real estate with the *right of redemption* to pay all sums due the seller and get clear title. No right of reinstatement exists with a land sales contract. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

However, as straight forward as the land sales contract may sound, it has proven to be an extremely fragile economic and legal affair.

## Figure 1

**FINANCIAL DISCLOSURE STATEMENT**

For Entering Into a Land Sales Contract

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

**NOTE:** This disclosure statement is required to be acknowledged by both the Seller (Vendor) and the Buyer (Vendee) when the Seller extends credit by the Buyer executing a debt obligation to pay for part of the sales price of property containing four-or-less residential units on a Land Sales Contract. [Calif. Civil Code §2956]

This disclosure is to be prepared and presented to all parties by the Broker of the party who offers or counteroffers to buy, sell or exchange on a Lease-Option sales agreement.

**DATE**: _____________, 20______, at ____________________________________________, California.

*Items left blank or unchecked are not applicable.*

**1. FACTS:**

This is an addendum to the following agreement:

☐ Offer for Land Sales Contract [See **ft** Form 167]
☐ Land Sales Contract [See **ft** Form 168]

1.1 dated _____________, 20______
1.2 entered into by ____________________________________________, as the Vendor, and
1.3 ____________________________________________, as the Vendee,
1.4 regarding property referred to as ____________________________________________.

**DISCLOSURES:**

**2. GENERAL INFORMATION CONCERNING TERMS OF PAYMENT:**

2.1 The balance of the purchase price due Vendor is $______________, payable in constant monthly installments of $______________, to include ______ % per annum interest, all due and payable with a final/balloon payment on _____________, 20______, in the approximate amount of $______________.

2.2 The Land Sales Contract provides for a final/balloon payment. Thus, the debt is not fully amortized. On the final/balloon payment date, the availability of refinancing, modification or extension of the final/balloon payment cannot be assured.

2.3 Vendor remains responsible to remit payments to Payees under senior encumbrances on receipt of installments paid by Vendee.

**Notice:** *The Vendor and Vendee may wish to use a collection agent for the purpose of accepting the Vendee's payments and disbursing payment to underlying lenders and the Land Sales Contract.*

2.4 This Land Sales Contract is subject to the following provision: "This Land Sales Contract is subject to section 2966 of the Civil Code, which provides that the holder of this instrument shall give written notice to the Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due." [See **ft** Form 419]

2.5 The Land Sales Contract wraps an existing trust deed, and any costs incurred by Vendor for prepayment penalties, late charges, due-on-sale or further encumbrance acceleration and future advances will be passed on to Vendee for payment. [See **ft** Form 168]

**3. SPECIAL PROVISIONS AND DISCLOSURES:**

3.1 ☐ Vendor will be designated as loss payee under Vendee's hazard and fire insurance, or
☐ Vendee will be designated as loss payee under Vendor's hazard and fire insurance.

3.2 Requests for Notice of Default and Notice of Delinquency under California Civil Code sections 2924b and 2924e ☐ will, or ☐ will not, be recorded for notice to Vendee on encumbrances senior to the Land Sales Contract. [See **ft** Form 167 §14]

3.3 The land sales contract transaction ☐ will, or ☐ will not, be escrowed for the delivery of the signed Land Sales Contract to Vendor and possession to Vendee.

3.4 The Land Sales Contract ☐ will, or ☐ will not, be recorded. The lack of a recording may impair Vendee's interest in the property if liens attach to Vendor's interest in the property.

3.5 Vendee's policy of title insurance ☐ will, or ☐ will not, be obtained from a title insurance company.

3.6 No tax reporting service will be obtained. If an impound rider is agreed to, Vendee will confirm the real estate taxes are paid by Vendor. If no impound rider is agreed to, Vendor will confirm the real estate taxes are paid by Vendee.

3.7 Vendee shall receive no proceeds or cash back on execution of the Land Sales Contract.

3.8 Vendor is aware his sole source of recovery on Vendee's default is limited to the credit bid or net proceeds from Vendor's foreclosure under the Land Sales Contract. [Calif. Code of Civil Procedure §580b]

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*PAGE TWO OF TWO — FORM 300-1*

**4. ENCUMBRANCES SENIOR TO THE LAND SALES CONTRACT:**

4.1 The conditions of encumbrances with priority over the Land Sales Contract include:

| | First Loan | Second Loan |
|---|---|---|
| Original balance: | $______________ | $______________ |
| Current balance: | $______________ | $______________ |
| Interest rate: | _____% ☐ ARM | _____% ☐ ARM |
| | Type __________ | Type __________ |
| Monthly payments: | $______________ | $______________ |
| Due date: | ________, 20____ | ________, 20____ |
| Balloon payment: | $______________ | $______________ |
| Current defaults: | $______________ | $______________ |

4.2 If any of the senior encumbrances contain a due date for a final/balloon payment, it may be difficult or impossible to refinance, modify or extend the balloon payment in the mortgage marketplace.

**5. VENDEE CREDIT INFORMATION:**

5.1 ☐ Vendee to hand Vendor a completed credit application on acceptance [See **ft** Form 302]; and

5.2 Vendor may terminate this agreement within ______ days of Vendor's receipt of Vendee's credit application by delivering to Vendee or Vendee's Broker a written Notice of Cancellation based on disapproval of Vendee's credit. [See **ft** Form 183]

**6. BROKER DISCLOSURES:**

6.1 Credit data is supplied by Vendee. Broker knows of no falsity or omission concerning Vendee's credit information.

6.2 This statement and its contents, being statutorily required disclosures, do not limit Broker's duties to disclose other facts material to Vendee or Vendor.

6.3 This statement is an addendum to the agreement referenced at §1 and creates no rights to rescind the Land Sales Contract.

6.4 This statement was prepared by ____________________________________________
____________________________________________

**7. OTHER:** ____________________________________________
____________________________________________
____________________________________________
____________________________________________
____________________________________________

| | |
|---|---|
| **Buyer's Broker:** ____________________ | **Seller's Broker:** ____________________ |
| **DRE #:** ____________________ | **DRE #:** ____________________ |
| By: ____________________ | By: ____________________ |
| **I have received and read a copy of this statement.** | **I have received and read a copy of this statement.** |
| Date: ___________, 20______ | Date: ___________, 20______ |
| Vendee: ____________________ | Vendor: ____________________ |
| Vendee: ____________________ | Vendor: ____________________ |

**FORM 300-1** 03-11 

Although a land sales contract with a power-of-sale provision is accorded the same statutory treatment as a trust deed, courts give unequal treatment to the defaulting buyer under a land sales contract which is devoid of a power-of-sale provision. Most land sales contracts provide no such power of sale and must be **judicially foreclosed** on a default.

A defaulting buyer who has built up a substantial equity under a **land sales contract** has an unconditional right to complete the purchase by paying the entire remaining balance, a *redemption*. However, the buyer has no *right to reinstate* on a default, unless the contract includes terms for a reinstatement or a trustee's power-of-sale provision (which automatically permits the rights of reinstatement and redemption). [**Petersen** v. **Hartell** (1985) 40 C3d 102]

The trend is to regard the land sales contract without a power-of-sale provision as a mortgage. A mortgage bears no legal difference from a carryback trust deed, except for the lack of a power-of-sale provision and the owner's **right to reinstate** on a default, all of which accompanies the trustee's power-of-sale foreclosure process. [**Perry** v. **O'Donnell** (9th Cir. 1985) 759 F2d 702]

A basic land sales contract is an agreement to convey title to the buyer when the buyer **fully satisfies** the dollar amount remaining unpaid on the purchase price, sometimes called a *contract for deed*.

Also, to fit within the statutory definition of a land sales contract, the agreement to convey title must not call for the transfer of title until more than one year has passed after the buyer is given possession of the property. [Calif. Civil Code §2985]

The seller under the land sales contract, recharacterized as a *vendor*, retains legal title **as security** for the buyer's promised payment of the balance of the purchase price. The buyer, recharacterized as a *vendee*, receives possession of the property and automatically becomes the **equitable owner** of the property.

Although the unrecorded land sales contract is often used to mask a sale of real estate, the sale is actually completed when the land sales contract is signed by the parties and delivered to the seller in exchange for the transfer of possession of the property to the buyer. A small downpayment to the seller usually accompanies the transaction.

Conveyance of title to the buyer usually occurs years later when a formal sales escrow is opened to complete the seller's performance of the land sales contract, an event no different in legal and financial effect than the **reconveyance of a trust deed lien** from title on payment in full.

The *conveyance escrow* is not a "sales escrow" at all. It is merely the means used to pay off and release the seller's security interest in the property under the land sales contract. The seller had retained title to the property not as owner, but as the holder of security for the remaining unpaid balance on the credit sale. But what escrow records and the assessor sees is a sale, not the mortgage-burning party it is.

**The contentious contract**

The buyer and seller should determine and analyze the risks and benefits accompanying their use of an unescrowed, unrecorded and uninsured **land sales contract** before they either:

## Figure 2

### OFFER FOR LAND SALES CONTRACT

**Prepared by: Agent** ____________ **Phone** ____________
**Broker** ____________ **Email** ____________

**NOTE:** To be used with Land Sales Contract Form 168 published by **first tuesday**.

**DATE:** ________, 20____, at ____________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** Received from ____________________, as the Buyer(s),
1.1 the sum of $________, evidenced by ☐ personal check, or ☐ ____________,
payable to ____________________, for deposit only on acceptance of this offer.
1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
1.3 situated in the City of ____________, County of ____________, California,
1.4 referred to as ____________________,
1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

**2.** This agreement is comprised of this three-page form and ______ additional pages of addenda/attachments.

**TERMS:**

**3. Buyer to purchase the property for the price of** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . **$**____0.00
3.1 The cash down payment on the price on entering into the Land Sales Contract. . . . . . $________
3.2 The balance of the purchase price is the sum of . . . . . . . . . . . . . . . . . . . . . . . . . . . $________
a. bearing interest from the date of ☐ the Land Sales Contract, or ☐ ________, 20____, on unpaid principal at the annual rate of ______%,
b. payable in installments of $________, or more, on the ________ day of each consecutive month beginning on the ________ day of ________, 20____, and continuing until ________, 20____, when the principal is due and payable.

**CONDITIONS:**

**4.** This Offer shall be deemed revoked unless accepted in writing ☐ on presentation, or within ______ days after date, and acceptance is personally delivered to Offeror or Offeror's Broker within the period.
4.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

**5.** Buyer(s) and Seller(s) hereby approve the Land Sales Contract Form 168 published by **first tuesday** and agree to sign an original copy, held by Broker, within ______ days of receipt of the prepared Land Sales Contract. Broker will deliver the signed Land Sales Contract to Seller and keys/access codes to Buyer, along with possession, on ________, 20____. [See **ft** Form 168]

**6.** Title is subject to current property taxes, covenants, conditions, restrictions, reservations and easements of record. Title is encumbered with the following debt obligations payable by Seller under the Land Sales Contract:
6.1 Trust deed note with an unpaid balance of $________, principal and interest payments being $________ monthly ________, including interest at ______%, ☐ adjustable, monthly impounds being an additional $________. The note and trust deed contain provisions for ☐ due-on sale, ☐ prepayment penalty of ____________________.
6.2 Trust deed note with an unpaid balance of $________, principal and interest payments being ________ monthly, including interest at ______%, due ________, 20____.
6.3 Bond or assessment liens of record in the amount of $________.

**7.** If an **Homeowners' Association** (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed copies of the HOA's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.
7.1 Current monthly assessment is $________. No association claims for defects or changes in regular or special assessments are pending or anticipated.
7.2 Seller is not in violation of CC&Rs, except ____________________.
7.3 Seller to pay association document and transfer fees.
7.4 Buyer to approve the HOA's statement of condition of assessments and confirm representations in subsection "a." above as a condition for closing escrow.

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7.5 Within ten days of Buyer's post-acceptance receipt of the HOA's documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See **ft** Form 183]

**8.** Seller's Neighborhood Security Disclosure Statement [See **ft** Form 321]
8.1 ☐ is attached, or
8.2 ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

**9.** ☐ Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]
9.1 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness. [See **ft** Form 183]

**10.** ☐ Parties to sign attached Land Sales Contract Financial Disclosure Statement. [See **ft** Form 300-2]

**11.** Seller to furnish prior to transfer of possession:
11.1 ☐ a structural pest control report and clearance.
11.2 ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.
11.3 ☐ a one-year home warranty policy:
Insurer ____________________
Coverage ____________________.
11.4 ☐ a certificate of occupancy, or other clearance or retrofitting, as required by local ordinance for the transfer of possession or title.

**12.** Seller's Natural Hazard Disclosure Statement [**ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to buyer prior to acceptance. [See **ft** Forms 182 and 183]

**13.** Seller's Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **ft** Form 304]:
13.1 ☐ is attached; or
13.2 ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance [See **ft** Form 269]. Seller to repair, replace or correct noticed defects prior to closing.
13.3 On Seller's failure to repair, replace or correct noticed defects, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See **ft** Form 183]

**14.** Buyer acknowledges receipt of a booklet and related Seller disclosures containing: ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978, one-to-four units) [See **ft** Form 313], and ☐ *The Homeowner's Guide to* Earthquake Safety (on all pre-1960, one-to-four units). [See **ft** Form 315]

**15.** ☐ Seller to provide a Request for Notice of Default and Notice of Delinquency to underlying lenders. [See **ft** Form 412]

**16.** Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, TV antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

**17.** This property is located in a(n): ☐ Industrial use area, ☐ Military ordnance area, ☐ Airport influence area, ☐ Rent Control Area, ☐ ____________________

**18.** Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

**19.** If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

**20.** Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice. [See **ft** Forms 172-2 or 173-2]

**21.** Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $________, or ☐ the deposit receipted in Section 1.

**22.** Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at

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www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP Code in which he or she resides.

**23.** Buyer to obtain hazard and personal liability insurance to cover Buyer's interest in the property.

**24.** Seller to pay a brokerage fee of $________ on entering into the Land Sales Contract and $________ on payoff of the balance due on the Land Sales Contract. Seller's Broker and Buyer's Broker, respectively, to share the brokerage fee ________:________.

**25.** ☐ See attached Agency Law Disclosure. [See **ft** Form 305]

**26.** ☐ See attached Notice of Supplemental Property Tax Bill. [See **ft** Form 317]

**27.** ____________________

| | |
|---|---|
| Buyer's/ Selling Broker: ____________ | Seller's/ Listing Broker: ____________ |
| Broker's DRE Identification #: ________ | Broker's DRE Identification #: ________ |
| Selling Agent: ____________ | Listing Agent: ____________ |
| Agent's DRE Identification #: ________ | Agent's DRE Identification #: ________ |
| Signature: ____________ | Signature: ____________ |
| Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer. | Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer. |
| Address: ____________ | Address: ____________ |
| Phone: ________ Cell: ________ | Phone: ________ Cell: ________ |
| Fax: ____________ | Fax: ____________ |
| Email: ____________ | Email: ____________ |

| | |
|---|---|
| **I agree to the terms stated above.** | **I agree to the terms stated above.** |
| ☐ See Signature Page Addendum. [**ft** Form 251] | ☐ See Signature Page Addendum. [**ft** Form 251] |
| Date: ________, 20____ | Date: ________, 20____ |
| Buyer: ____________ | Seller: ____________ |
| Signature: ____________ | Signature: ____________ |
| Buyer: ____________ | Seller: ____________ |
| Signature: ____________ | Signature: ____________ |

- sign and deliver an offer to purchase on a land sales contract [See Figure 2]; or
- sign and deliver the land sales contract and transfer downpayment funds and possession. [See Figure 3]

Typically, when a land sales contract is used, the formal aspects of an escrowed sale of real estate are imprudently deferred until a “sales escrow” is opened to handle the buyer’s payoff and the seller’s transfer of record title to close out the land sales contract.

The later sales escrow, used to satisfy the land sales contract by final payoff, fails to reflect the fact that the actual sale occurred years earlier when the buyer and seller entered into the land sales contract.

The sales escrow, opened to close out the land sales contract transaction, is for the purpose of either:

- a full conveyance and refinancing of the property with a new lender who provides funding for the payoff of the debt owed to the seller on the land sales contract; or
- a seller “rollover” of the remaining contract debt into a note and trust deed, executed by the buyer and received by the seller on a transfer of the title to the buyer.

All costs of a conventional closing incurred in a formal sales escrow, also called *transactional costs*, are avoided at the time of entering into a land sales contract. A seller and a buyer choosing to use a land sales contract rarely if ever escrow the land sales contract transaction, obtain title insurance or local government occupancy or retrofit certificates.

The closing costs are actually deferred until a sales escrow is opened to complete performance of the land sales contract and convey title to the buyer.

Closing costs on a sale include escrow fees, recording costs, title insurance premiums, a beneficiary statement and assumption or loan fees. Reassessment, supplemental tax bills and income taxes are soon to follow these fees.

Often the payment of brokerage fees is in large part deferred as a fractional ownership in, or a lien on, the land sales contract until the seller is paid in full through the sales escrow.

**Due-on-sale and reassessment**

Consistent with their rationale for not recording a land sales contract, a buyer and seller do not request a **beneficiary statement** from the lender or a **waiver** of the lender’s right to call or recast the loan on transfer of equitable ownership.

Thus, sellers and buyers often mistakenly believe an unrecorded sale of real estate (such as a sale on a land sales contract), which is not brought to the attention of the lender or the county assessor, does not trigger the due-on clause or reassessment as a sale and change of ownership.

On the contrary, entering into a land sales contract triggers both the **due-on clause** in an existing trust deed as a transfer of an interest and **reassessment** as a change of ownership, even if the land sales contract document is not recorded.

Whenever the holder of a trust deed containing a due-on clause discovers the secured property has been sold on a land sales contract, the lender can enforce the due-on clause. Likewise, the county assessor can retroactively reassess on their discovery of the sale.

### Contract escrows for delayed recording

Escrow companies have contributed to the creative chaos scene in the form of the **contract escrow**.

The contract escrow actually involves two escrows.

On the close of the sales escrow, the cash down payment is disbursed to a seller. However, all documents normally recorded, such as a grant deed and a trust deed, are placed in a second "holding" escrow. Nothing is recorded, but the proper documentation has been completed.

The sale of property has been closed for purposes of reassessment, due-on-sale and income tax.

The second contract escrow holds the documents until a written request from the buyer or the seller is received by escrow instructing them to record the grant deed and trust deed.

Since both the seller and the buyer have an insurable interest in the property, two separate policies of **fire and hazard insurance** are frequently obtained — one for the seller and another for the buyer. Alternatively, an agreement is entered into by the buyer and seller giving the buyer an interest in the proceeds of the insurance policy.

The carryback note is often placed on contract collection with the same escrow company.

### Unexecuted purchase agreements, extended escrows

Similar in approach to the land sales contract is the transfer of possession to the buyer under an **unexecuted purchase agreement**, as a sales escrow will not be closed for an extended period of time.

Here, a **marketing instrument** is used, such as a regular purchase agreement form. The purchase agreement is turned into a **security device** characteristic of a land sales contract or lease-option. The purchase agreement contains a provision for transfer of possession and buildup of equity by a credit to the purchase price for a portion of the buyer's payments to the seller, called a *lease-purchase sale*.

For example, a buyer and a seller sign a standard purchase agreement.

An escrow is opened. A grant deed, a carryback note, a trust deed, and the down payment are deposited into escrow within 30 to 60 days.

However, the closing and disbursement of funds are delayed until after one to three years of timely performance by the buyer.

During the extended escrow period, payments are made to the seller which include credit of a portion of the payment toward the down payment (or price) called for in the purchase agreement. Often, the buyer's payments are sent to the same escrow company that received the down payment and documents.

Since the buyer wants to take possession of the property prior to the close of escrow, he enters into an interim occupancy (lease) agreement with the seller. Neither the lease nor the escrow will extend beyond three years, which would avoid triggering any due-on clauses.

Should the seller enter into a lease for more than three years or apply payments toward the purchase price, the transfer of possession will qualify as a sale, triggering reassessment, profit tax reporting, the lender's right to accelerate the loan, etc. [12 CFR §591.2(b)]

For the buyer to protect any increase in the property's value which occurs by the end of the occupancy period, the buyer must:

- timely close the long-term escrow;
- renew or extend the lease; or
- find a buyer who will purchase his position.

**The lease-option sale**

Buyers and sellers of real estate must understand that a sale structured as a *lease-option* is still a sale. The form used to structure the sale does not change a buyer's and seller's rights and obligations which are provided by mortgage and contract law.

Moreover, a seller seeking to disguise a sale as a **lease-option** transaction creates risks that are eliminated by more conventional wraparound formats, like the all-inclusive trust deed (AITD).

A sale documented as a lease and option to purchase typically lacks a **power-of-sale** provision which allows for a trustee's foreclosure — the seller's best remedy to recover the property (title and possession) should the buyer default. [See Figure 3]

The lease-option sale usually is not documented through an escrow, nor is there delivery of a grant deed or a note and trust deed. Instead, the buyer will lease the home with an option to purchase it at a **predetermined price**, not a price based on market value at the time of exercising the option.

The down payment, called *option money,* is applied toward the purchase price of the property, should the option be exercised. Similarly, a portion of the monthly payment, called rent, will apply as principal paid toward the price on exercise of the option prior to its expiration. Of course, the expiration of the option is the legal equivalent of a due date for payment of the balance of the purchase price. [See Figure 4]

However, when a tenant receives credit toward the purchase price on payment of his option money or rent, the lease-option is recharacterized as a land sales contract, mortgage or trust deed for all purposes. Also, a carryback sale structured as a lease-option will typically be devoid of a trust deed power- of-sale provision, prohibiting the seller from rapidly foreclosing by a trustee's sale and wiping out the equity the buyer has paid for and built up in the property.

Except for the absence of legal documentation in the form of a grant deed, note and trust deed, the terms of the lease-option sale have all the **economic characteristics** of a credit sale. There is an agreed-to price, a down payment, monthly rent payments which apply in whole or in part toward principal (the balance being interest) and a due date for the final/balloon payment.

When a buyer in possession of property under an agreement with the seller receives credit toward the purchase price for a portion or all of his payments to the seller, he has built up and established an **equity** in the property. Thus, he has an **ownership interest** which carries with it the *right of redemption* to pay off the seller and get clear title. The buyer's redemption rights can only be terminated by a judicial or nonjudicial foreclosure, or a deed-in-lieu of foreclosure for which the seller (lender) usually needs to pay "key money" to get possession.

A lease-option agreement structured on terms economically consistent with a credit sale (a down payment or credit of payments toward the price) is neither a lease between a tenant and a landlord nor an option to buy. The lease-option sales agreement is a **disguised security device** for credit financing of a sale arranged by a buyer and a carryback seller. [**Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798]

An actual lease coupled with a separate option to buy is the antithesis of seller financing. A borrower's debt obligations and a lender's foreclosure rights are diametrically opposed to a tenant's leasehold obligations and the eviction rights of a landlord.

Also, all lease-options trigger due-on provisions in trust deeds which encumber property.

**Tax aspects**

Taxwise, **lease-option sales** are recharacterized by the Internal Revenue Service (IRS), the state Franchise Tax Board (FTB) and the county assessor as carryback financing or land sales contracts.

One reason sellers conceal property sales behind the format of a lease-option is to avoid added tax burdens on a change in ownership. Under an actual option agreement, any option money received by the seller is reported as either **profit or income** when the option is **exercised or expires**, or the property is sold subject to the option.

The seller, disguised as a landlord, will also deduct the amount of the property's annual depreciation to reduce income taxes, until the lease-option is recharacterized by the IRS as a sale.

Buyers are motivated to structure a sale as an unrecorded lease-option to evade property **reassessment** by the county. However, the use of a lease-option to mask a sale has property tax consequences, since the economic characteristics of the transaction constitute a change of ownership, triggering retroactive reassessment when later discovered.

## Figure 3

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

**LAND SALES CONTRACT**

All-Inclusive with Power of Sale

**Prepared by: Agent** ____________________ **Phone** ____________________
**Broker** ____________________ **Email** ____________________

*Items left blank or unchecked are not applicable.*

This Agreement, made this __________ day of __________, 20____, between ________________________________, as the Vendor, and ________________________________, as the Vendee, whose address is ________________________________,
(Number and street) (City) (State) (Zip)
regarding the real property in the City of ________________________________, County of ________________________________, California, referred to as

**1. Subject to the following trust deeds and notes referred to as Underlying Obligations:**

1.1 A trust deed recorded ______________, as Instrument No. __________ in Official Records of ____________________ County, California, executed by ____________________, as Trustor, in which ____________________ is Beneficiary, securing a note in the original amount of $__________, with an unpaid balance of $__________ payable in installments of $__________ monthly including _____ % annual interest, ☐ ARM, ☐ plus payments for impounds ____________________.

1.2 A trust deed recorded ______________, as Instrument No. __________ in Official Records of ____________________ County, California executed by ____________________, as Trustor, in which ____________________ is Beneficiary, securing a note in the original amount of $__________, with an unpaid balance of $__________ payable in installments of $__________ monthly including _____ % annual interest, ☐ ARM, all due ______________.

1.3 ☐ See attached addendum for additional Underlying Obligations.

1.4 Vendor to remain responsible for and to pay all amounts called for in the Underlying Obligations.

**2. Vendee hereby purchases the property for the price of** . . . . . . . . . . . . . . . . . . . . . . . . $__________

2.1 The cash down payment on the price on entering into this agreement is the amount of. . $__________

2.2 The balance of the purchase price is the unpaid sum of. . . . . . . . . . . . . . . . . . . . . . $__________ bearing interest from date of ☐ agreement, or ☐ ____________________, on unpaid principal at the annual rate of _____ %, payable in installments of $__________, or more, on the _____ day of each consecutive month beginning on the _____ day of ______________ and continuing until __________, 20_____, when the principal is due and payable.

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— — — — — — — — — — PAGE TWO OF THREE — FORM 168 — — — — — — — — — —

**3. Vendor retains legal title for the purpose of securing payment of:**

a. The balance of the purchase price;
b. Any additional sums and interest hereafter loaned by Vendor to Vendee, or their assignee, evidenced by a promissory note or notes, referencing this agreement as security for payment;
c. The Vendor's charge for a statement regarding the secured obligations requested by or for Vendee; and
d. The performance of each provision contained in this agreement.

**VENDEE AGREES:**

**4. Condition of Property** — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

**5. Hazard Insurance** — Vendee will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which the Vendor requires insurance. The insurance shall be maintained in the amounts and for the periods the Vendor requires. The insurance carrier providing the insurance shall be chosen by Vendee, subject to Vendor's approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Vendor, and contain loss payable clauses in form acceptable to Vendor. Vendor shall have the right to hold policies and renewals.

In the event of loss, Vendee shall promptly notify the insurance carrier and Vendor. Vendor may make proof of loss if not made promptly by Vendee. Vendor may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Vendee fails to reconstruct, Vendor may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

**6. Indemnity** — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Vendor; and to pay all costs and expenses.

**7. Taxes and Senior Encumbrances** — To pay all taxes and assessments affecting the property, including water stock assessments, at least 10 days before delinquency; all encumbrances, charges and liens, with interest, on the property when due, which are not the responsibility of the Vendor and are or appear to be senior to this agreement; and all expenses of this agreement.

**8. Acts and Advances to Protect the Security** — If Vendee fails to make any payment or to perform any act provided for in this agreement, then Vendor may, at the option of the Vendor and without notice, and without releasing Vendee from any obligation under this agreement:

a. Make or do the same to the extent necessary to protect the security, Vendor being authorized to enter upon the property to do so;
b. Appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Vendor;
c. Pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this agreement.
d. In exercising the power of this provision, Vendor may incur necessary expenses and reasonable attorney fees. Vendee to pay immediately all sums expended by Vendor provided for in this agreement, with interest from date of expenditure at the same rate as the principal debt hereby secured.

**VENDOR AND VENDEE AGREE:**

**9. Assignment of Damages** — Vendee assigns to Vendor any award of damages made in connection with:

a. Condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or
b. Injury to the property by any third party.

**10. Waiver** — By accepting payment of any sum due after its due date, Vendor does not waive Vendor's right to either require prompt payment when due of all other sums or to declare default for failure to pay. Vendor may waive a default of any provision of this agreement, by consent or acquiescence, without waiving any prior or subsequent default.

**11. Conveyance of Title** — Vendor to convey title free of creditor's liens, subject to existing CC&Rs, to Vendee upon Vendee's payment of all sums due to Vendor under this agreement.

11.1 On conveyance of title from Vendor to Vendee on full performance of this agreement by Vendee, the interest of Vendor and Vendee in the property will be insured by a title insurance policy issued by ____________________ Title Insurance Company, premium to be paid by ☐ Vendor, or ☐ Vendee.

11.2 On Vendee's deposit into escrow of all sums and instruments due to Vendor under this agreement and payment of all customary escrow costs and charges, Vendor to deposit into the escrow all instruments and instructions necessary to convey title and fully perform this agreement.

**12. Due-on-sale** — Should Vendee sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, Vendor may, at Vendor's option, declare all sums secured by this agreement immediately due and payable.

**13. Assignment of Rents** — Vendee hereby assigns and transfers to Vendor all the rights, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this agreement.

Prior to a default on the trust deed by Vendee, Vendee shall collect and retain the rents. On default by Vendee, and without the necessity of Vendor to make demand or take possession of the property in person, by agent or by court appointed receiver, Vendor shall immediately be entitled to possession of all unpaid rents.

— — — — — — — — — — PAGE TWO OF THREE — FORM 168 — — — — — — — — — —

— — — — — — — — — — PAGE THREE OF THREE — FORM 168 — — — — — — — — — —

**14. Acceleration** — If payment of any indebtedness or performance of this agreement is in default, then Vendor may at Vendor's option, without notice, declare all sums secured immediately due and payable by:

a. Commencing suit for their recovery by foreclosure of this lien; or
b. Delivering to Trustee a written notice declaring default with demand for sale; a written notice of default and election to sell to be recorded.

**15. Power of Sale** — On default under any obligation of this agreement and acceleration of all sums due, Vendor may elect to proceed with a power of sale by a trustee substituted under Civil Code §2934a, noticed and held in accordance with California Civil Code §2924 et seq.

15.1 The undersigned Vendee requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Vendee at the address herein set forth.

**16. Prepayment Penalty** — Any principal paid in addition to regular installments will, if so requested by Vendee, be paid by Vendor to holders of Underlying Obligations for a reduction in the principal. If the holders are entitled to a prepayment penalty, Vendee shall pay the amount to Vendor for payment of the penalty. The prepayment penalty will not reduce the unpaid balance of principal or accrued interest on the debt remaining on this agreement.

**17. Cure of Default** — If Vendor defaults in his performance on this agreement, including payment of the Underlying Obligations, Vendee may cure the default and credit the payments against the principal and interest due under this agreement, or recover from Vendor, on demand, the amount of the payments including interest thereon at the note rate.

**18. Successors, Assigns and Pledgees** — This agreement is for the benefit of, and binds all parties, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term "Vendor" shall mean the holder and owner of the agreement, or, if the agreement has been pledged, the pledgee.

**19. Vendee's Offset Statement** — Within 10 days of Vendee's receipt of a written request by Vendor, Vendee shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of the Vendor: the then owner of the secured property; the terms of the secured debt, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured debt is valid and the Vendee received full and valid consideration for it; and that the Vendee understands the debt and this agreement are being assigned.

**20. Final Balloon Payment Notice** — This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due.

**21. Addenda** — The following checked addenda are a part of this agreement: ☐ Impounds rider for taxes and insurance; ☐ Owner-occupancy rider; ☐ Contract collection rider; ☐ ____________________.

**22. Attorney Fees** — In any action to enforce this agreement, the prevailing party shall receive attorney fees.

| | |
|---|---|
| ☐ See attached Signature Page Addendum. [**ft** Form 251] | ☐ See attached Signature Page Addendum. [**ft** Form 251] |
| Vendor's Name: ____________________ | Vendee's Name: ____________________ |
| Signature: ____________________ | Signature: ____________________ |
| Vendor's Name: ____________________ | Vendee's Name: ____________________ |
| Signature: ____________________ | Signature: ____________________ |

STATE OF CALIFORNIA
COUNTY OF ____________________
On ____________________ before me,
____________________
(Name and title of officer)
personally appeared ____________________
____________________,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ____________________
(Signature of notary public)

(This area for official notarial seal)

FORM 168 03-11 

**Reverse trust deed**

The *reverse trust deed* is often used to provide recorded protection for a buyer's investment in an otherwise unrecorded transfer, such as one involving the two-step contract escrow.

As the name suggests, the economic roles of the buyer and seller in the transaction are reversed.

The buyer documents the amount of the down payment on the property as a loan made to the seller.

The seller, disguised as an owner borrowing money, signs a note for the amount of the down payment and a trust deed in favor of the buyer. The trust deed appears as the buyer's lien on the very property the buyer is acquiring, hence its name: reverse trust deed.

When escrow closes on the sale, the buyer's reverse trust deed is recorded (naming him as the beneficiary) and the seller receives the net proceeds from the down payment. The buyer takes possession of the property under a lease signed by both the seller (as the landlord) and the buyer (as the tenant).

All other documents regarding the buyer's **actual** purchase of the property — the executed grant deed and any carryback notes or trust deeds — are left unrecorded and placed into a contract or holding escrow. The escrow agent is **instructed** to hold these documents (together with the note and a request for a reconveyance of the reverse trust deed) until the buyer or seller requests they be recorded.

As a result, the record title  indicates the seller merely equity-financed his property.

Neither the lender nor the tax assessor are alerted to the transfer as long as the grant deed remains unrecorded and undisclosed. However, both the lender's due-on clause and the assessor's right to reassess have been triggered.

The reverse trust deed takes the place of the Memorandum of Agreement recorded in some contract escrow arrangements.

However, the reverse trust deed does present a degree of financial protection to the buyer. When recorded, it prevents the seller from defeating the buyer's down payment by further encumbering or deeding out the property to a bona fide purchaser (BFP). [**Miller** v. **Cote** (1982) 127 CA3d 888]

Should the seller interfere with the buyer's unrecorded grant deed interest, the buyer can foreclose on the trust deed and wipe out the seller's position.

However, the reverse trust deed is not perfect and has several potentially fatal flaws, both economic and legal.

Economically, price inflation or value appreciation of the property will cyclically outstrip the buyer's ability to protect his equity (due to the historical inflationary monetary policy of the

## Figure 4

**LEASE-OPTION**
Contract for Deed

**Prepared by: Agent** ______________ **Phone** ______________
**Broker** ______________ **Email** ______________

**NOTE:** This form is not for use by an investor acquiring owner-occupied, one-to-four unit residential property in forclosure. [See **ft** Form 156]

**DATE:** __________, 20____, at ______________________, California.

*Items left blank or unchecked are not applicable. References to forms include their equivalent.*

**FACTS:**

**1.** This lease agreement and option to purchase is entered into by Lessor/Optionor and Lessee/Optionee, regarding property situated in the City of ______________, County of ______________ California, referred to as ______________________________

Personal property, ☐ see attached Personal Property Inventory [See **ft** Form 256], ______________

**2. This agreement is comprised of this three page form and the following checked attachments:**
- ☐ Credit Application [See **ft** Form 302]
- ☐ Residential Earthquake Hazards Report [See **ft** Form 315]
- ☐ Occupant's Operating Expense Sheet [See **ft** Form 562]
- ☐ Addendum — General Use [See **ft** Form 250]
- ☐ Notice of Your Supplemental Property Tax Bill [See **ft** Form 317]
- ☐ Agency Law Disclosure Statement [See **ft** Form 305]
- ☐ Natural Hazard Disclosure Statement [See **ft** Form 314]
- ☐ Financial Disclosure Statement [See **ft** Form 309]
- ☐ Brokerage Fee Addendum [See **ft** Form 273]
- ☐ Lead-Based Paint Disclosure [See **ft** Form 313]
- ☐ Condition of Property Disclosure [See **ft** Form 304]

**3. Term of Lease:**
This lease commences __________, 20____ and continues until __________, 20____.

3.1 The lease terminates on the last day of the term without further notice.

3.2 If Lessee holds over, Lessee to be liable for rent at the daily rate of $__________.

**4. Rent:** Lessee to pay, in advance, a base monthly rent of $__________ due on the ____ day of each calendar month.

4.1 Rent to be paid by: ☐ personal check made payable to __________, or ☐ ______________.

4.2 Rent to be tendered by: ☐ mail, or ☐ personal delivery.

4.3 Lessee to pay a late charge of six percent of all rent amounts due in the event rent is not received within ten days of the due date.

4.4 Lessee to pay $__________ for each rent check returned for insufficient funds and thereafter pay rent by cash or cashier's check.

**5. Additional Rent:** In addition to the base monthly rent, Lessee to pay additional monthly rent equal to the increased costs incurred by Lessor after entering into this lease-option, due to:

a. ☐ variable/adjustable interest rate on existing loans secured by the property;
b. ☐ variable/adjustable monthly principal or acceleration of existing loans secured by the property;
c. ☐ property taxes on the property;
d. ☐ fire and extended coverage insurance premiums on the property;
e. ☐ any Homeowners' Association (HOA) assessments;
f. ☐ any special or improvement assessments on the property; and
g. ☐ any other expenditures required of Lessor to protect his interest.

5.1 The additional monthly rent shall be the actual monthly cost increase and 1/12th of any annual cost increase.

5.2 The additional monthly rent is due on, or beginning with, the monthly rent payment next due following notice to Lessee by Lessor.

**6. Utilities:** Lessee shall pay all costs of public utilities to the property, including any required deposits, installation, or service fees.

**7. Maintenance of Premises:** Lessee agrees to maintain and perform all necessary repairs to the property during the lease term at his sole expense.

*— PAGE ONE OF THREE — FORM 163 —*

*— PAGE TWO OF THREE — FORM 163 —*

**8. Insurance:** Lessee shall maintain at his sole expense, naming Lessor as an additional insured:

8.1 ☐ A standard fire insurance policy with extended coverage, vandalism and malicious mischief endorsements, fully covering the replacement cost of all structures on the property during the entire term of the lease; and

8.2 ☐ Public liability and property damage insurance with a single combined liability limit of at least $300,000 and property damage limits of at least $100,000, insuring against all liability of Lessee arising out of Lessee's use or occupancy of the premises.

**9. Use of the Property:** The property is to be used only as a private residence occupied by Lessee and for no other purpose. Lessee shall comply with all laws regarding the use of the property, and shall not allow any waste or nuisance to occur on the property.

**10. Assignment and Subletting:** Lessee shall not assign this lease, nor sublet or encumber any interest in the property without the prior written consent of Lessor. Any transfer of an interest in the property by Lessee without the prior written consent of Lessor shall, at the option of Lessor, terminate this lease and call for payment of all sums due.

**11. Waiver of Damage:** Lessee releases Lessor from liability for loss or damage to Lessee or any property of Lessee caused by water leakage, breaking pipes, theft, vandalism, or any other cause beyond the reasonable control of Lessor.

**12. Hold Harmless:** Lessee shall indemnify Lessor from liability, damages, and/or expenses arising from the death or injury of any person, including Lessee, or from the damage or destruction of any property, including property owned by Lessee, caused or allegedly caused by some condition of the property, or some act or omission of Lessee or any other person.

**OPTION TO PURCHASE:**

**13. Option Money:** Optionor acknowledges receipt of option money in the amount of $__________, given in consideration for this option to purchase the property leased.

**14. Option Period:** Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property under the sales terms for a period commencing with the acceptance of this option and expiring on termination of the lease.

**15. Exercise of Option:** Optionee may exercise this option during the option period by:

15.1 Preparing and signing escrow instructions with ______________________;

15.2 Depositing cash in Escrow of $__________; and

15.3 Delivering a certified copy of the signed escrow instructions to Optionor within the option period in person or by certified mail.

**16. Delivery of Title:** Within ____ days after exercise, Optionor and Optionee shall place in Escrow all documents and instruments necessary to close.

**17. Sale Terms:** The purchase price is $__________, payable:

17.1 ☐ In cash.

17.2 ☐ Down payment in the amount of $__________.

17.3 The cash price or down payment to be credited for $__________ of option money paid, and for ____%, or $__________, of each payment of base monthly rent.

17.4 ☐ Take title subject to, or ☐ Assume, the existing trust deed note with an approximate unpaid balance of $__________, currently payable $__________ monthly, including principal and interest at ____%, ☐ adjustable, monthly impounds being an additional $__________.

17.5 ☐ Take title subject to, or ☐ Assume, a trust deed note with a principal balance of $__________, currently payable $__________ monthly, including principal and interest at ____%, due __________.

17.6 Loan balance differences to be adjusted in: ☐ cash, ☐ §17.8 Note, or ☐ price.

17.7 ☐ Assume bonds or assessment liens of record in the approximate amount of $__________.

17.8 A Note for the balance of the purchase price in the amount of $__________, to be executed by Buyer in favor of Seller and secured by a trust deed on the property, payable $__________ monthly, or more, commencing one month after closing, including interest at ____%, due __________ years after closing.

a. The Note and Trust Deed shall not contain provisions for due-on clauses, prepayment penalties, or late charges.
b. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
c. ☐ The Note is an All-Inclusive Trust Deed Note.
d. As additional security, Optionee to execute a security agreement and file a UCC-1 financing statement on any personal property included in the price.

*— PAGE TWO OF THREE — FORM 163 —*

*— PAGE THREE OF THREE — FORM 163 —*

**18. General Provisions**:

18.1 Optionee's transfer of any interest in this option terminates the option.

18.2 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18.3 The prevailing party in any action on a dispute shall be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

**19. Power of Sale:** Should this document be characterized as a security device, on default of rental payments or failure to exercise the option, the Lessor/Optionor may call all sums due and elect to proceed with a power of sale by a trustee substituted under Civil Code §2934(a), noticed and held in accordance with Civil Code §§2924 et seq.

**20. Lessor/Optionor Default:** Should the Lessor/Optionor default on any obligation impairing the Lessee/Optionee's interest under this agreement, Lessee/Optionee may cure the default and demand reimbursement from the Lessor/Optionor of the amount advanced, and if not paid, deduct the amount paid from periodic payments and the purchase price due the Lessor/Optionor.

**21. Expiration of Option:** This option to purchase shall be deemed expired if not exercised during the option period, and if not previously terminated, shall automatically expire/terminate on __________, 20____.

**22. Brokerage Fee:** Optionor to pay brokerage fees as follows:

22.1 ____% of the option money on receipt; plus

22.2 ____% of each month's base rent on receipt; and

22.3 $__________ on exercise of the option.

22.4 Optionee's Broker and Optionor's Broker, respectively, to share the brokerage fee ____:____.

**23.** ______________________________

| | |
|---|---|
| Lessee/Optionee's Broker: __________ | Lessor/Optionor's Broker: __________ |
| By: __________ | By: __________ |
| Is the agent of: ☐ Lessee/Optionee exclusively, or ☐ both Parties | Is the agent of: ☐ Lessor/Optionor exclusively, or ☐ both Parties |
| **I agree to the terms stated above.** | **I agree to the terms stated above.** |
| ☐ See attached Signature Page Addendum. [**ft** Form 251] | ☐ See attached Signature Page Addendum. [**ft** Form 251] |
| Date: __________, 20____ | Date: __________, 20____ |
| Lessee/Optionee: __________ | Lessor/Optionor: __________ |
| Signature: __________ | Signature: __________ |
| Lessee/Optionee: __________ | Lessor/Optionor: __________ |
| Signature: __________ | Signature: __________ |
| Address: __________ | Address: __________ |
| Phone: __________ | Phone: __________ |
| Fax: __________ | Fax: __________ |
| Email: __________ | Email: __________ |

**FORM 163** **03-11** 

Federal government). Should the buyer ever need to foreclose to recover the amount of his down payment, he will only become the legal owner of the property if he is the successful bidder at a trustee's sale.

Of course, the buyer runs the risk of being overbid by other bidders who appear at the sale. At a minimum, the buyer as the foreclosing beneficiary of the trust deed will get back the amount of his original down payment, plus interest.

Legally, the reverse trust deed is even more disenchanting than lost inflation or appreciation. Even if the buyer could bid high enough at the trustee's sale to acquire title, he still stands to lose the property if the senior lender calls the loan, and if unpaid, forecloses.

If the property is an owner-occupied, one-to-four unit residential property, the owner (meaning the seller, not the buyer) can further encumber and avoid a call under the existing lender's due-on clause only if he **continues to occupy** the property. [12 CFR §591.5(b)(1)(i)]

Thus, the very purpose for using a reverse trust deed (to transfer possession without the risk of the due-on-sale/reassessment) renders it **legally useless**, except to foreclose on the property, since the reverse trust deed does not avoid a call or the recasting of the existing financing or a reassessment when the transaction is discovered by the lender or the county assessor.

Taxwise, a reverse trust deed transaction, unless reported as a sale, exposes the seller to liability for **tax evasion** for deliberately restructuring a sale to appear as a non-taxable event (a loan).

The substance and function of the transaction (the sale of the property) supersedes its recorded form (the trust deed loan).

Also, concealing the sale from the county assessor results in the imposition of stiff property tax penalties by the county tax collector. The seller is also faced with penalties for his failure to report profit to the Internal Revenue Service (IRS) and California's Franchise Tax Board (FTB).

When the grant deed is eventually recorded, its date prepared and notarized will probably alert the assessor to the unrecorded transfer of the property, which occurred a few years earlier. Then the retroactive assessment and tax bills will start arriving — to be paid.

**Filing the IRS 1099-S**

When a formal sales escrow is not used to handle documents and funds on a sale, the person arranging the sale, generally the broker, is required to report the transaction to the Internal Revenue Service (IRS) on a 1099-S form. [Revenue Regulations §1.6045-4(a)]

The IRS recognizes the sale date to be the earlier of the dates on which:

- title is transferred; or
- the economic benefits and burdens of ownership shift from the seller to the buyer. [Rev. Reg. §1.6045-4(h)(2)(ii)]

Typically, reporting the sale to the IRS with a 1099-S form is incorrectly deferred until the title is conveyed to the buyer through escrow on payoff of the land sales contract, lease-option or other masked security device or off-record handling.

Here again, escrow improperly collaborates with the seller, buyer and broker to prevent discovery of the previously masked sale by all persons or agencies, even when escrow closes and reports the closing as the date of the sale.

# Chapter 27 — Usury and the private lender

*This chapter explains the private lender's exemption from usury limitations when the loan is arranged by a licensed real estate broker.*

***Chapter 27 Outline***

*Broker arranged loans avoid usury*
*Usury exemptions spur competition*
*Interest paid with goods and services*
*Setting the interest rate*
*Usury law and real estate loans*
*Exceptions for private parties*
*Penalties for usury*
*Usurious loans to a broker/borrower*
*Agents and usury*

***Chapter 27 Terms***

| | |
|---|---|
| *Excluded debts* | *Loan-sharking* |
| *Exempt debts* | *Non-exempt private lenders* |
| *Forfeiture of interest earnings* | *Threshold rate of interest* |
| *Interest* | *Usurious* |

**Broker arranged loans avoid usury**

When a loan is made, the lender charges the borrower *interest* for use of the money during the period lent. However, the amount of **interest** a private, non-exempt lender can charge is regulated by statute and the California Constitution, called usury laws. [Calif. Constitution, Article XV; Calif. Civil Code §§1916-1 through 1916-5]

Today, the remaining goal of usury laws is the prevention of *loan-sharking* by private lenders — charging interest at a higher rate than the ceiling-rate established by the usury laws, a *threshold rate of interest* beyond which the non-exempt loan becomes categorized as *usurious*. [CC §1916-3(b)]

**Usury exemptions spur competition**

Adopted in 1918 as a consumer protection referendum, the first California usury laws set the maximum interest rate at 12% for **all lenders**; no exceptions.

During the Depression, legislators noted the adverse effect the ceiling-rate restriction on interest rates money lenders could charge was having on the money supply and the economy.

So, in 1934, usury laws were constitutionally amended in a trade off — lowering the maximum rate to 10% while exempting several classes of significant lenders entirely.

Lenders such as savings and loan associations (S&Ls), state and national banks, industrial loan companies, credit unions, pawnbrokers, agricultural cooperatives and personal property brokers could lend at whatever rate the market would bear without fear of penalty *by forfeiture of interest earnings*.

Exemptions successfully opened the market by increasing the availability of funds. In turn, interest rates were driven lower due to increased competition.

When money grew tight again in the late 1970s, legislators applied the same strategy to loosen up what had by then become massive amounts of funds held by individuals in savings accounts by initiating a proposition in 1979.

On passage of the 1979 initiative, real estate loans **made or arranged** by real estate brokers were added to the list of usury-exempt lender situations. [Cal. Const. Art. XV]

The 1979 law also gave the legislature the power to exempt other classes of lenders from usury limits. The legislature has since exempted corporate insurance companies and consumer finance lenders, but not CalPers.

**Interest paid with goods and services**

When a borrower pays interest on a loan, he is really paying rent to the lender for use of his money for a period of time. The money lent is fully repaid during or at the end of the period.

Normally, the amount of interest charged is a fixed or adjustable percentage of the amount of money loaned.

Though interest is commonly paid with money, interest may also be paid with personal property or services. The many **types of consideration** given for making a loan become part of the lender's yield on the loan—interest. [CC §1916-2]

Thus, **interest** includes the value of all compensation a lender receives for lending money, whatever its form, excluding reimbursement or payment for loan origination costs incurred and services rendered by the lender. [CC §1915]

However, it is common for *non-exempt private lenders* to attempt to evade the usury law restrictions on interest and the payment of taxes by including bogus charges or claiming fees—points for their making the loan.

Any lender can charge the borrower a bonus, commission or discount, or receive services or goods from the borrower. However, charges and receipts are considered interest only when they do not compensate or reimburse the lender for services rendered in the process of originating the loan.

Charges unrelated to loan origination services are added to the interest stated in the note to determine the aggregate yield on the principal. The average annual yield over the life of the loan may not exceed the *threshold rate* which triggers application of the usury laws — unless the loan transaction is exempt. [**Haines** v. **Commercial Mortgage Co.** (1927) 200 C 609]

### Determining the Federal Discount Rate

The discount rate set periodically by the *Federal Reserve Bank of San Francisco (FRBSF)* is the rate the "Fed" charges member banks on advances of funds – money lent by the Fed. The discount rate is reviewed no less than once every fourteen days by the Board of Directors of the Federal Reserve Bank of San Francisco. A review can bring a change in the discount rate – depending on how the directors view the economic health of the region, nation and world. For monthly updates of the Discount Rate, see the **first tuesday** Market Charts at *firsttuesdayjournal.com*.

The maximum interest rate allowable beyond the 10% minimum threshold rate for usury limitations on real estate loans that are not exempt from usury law is calculated and set for each month. The usury threshold rate set for a particular month applies to only those loan transactions entered into any time during that month. A fixed rate of interest is then attached to that loan for the life of the loan.

The Federal Reserve discount rate used in the calculations for setting the usury threshold rate for non-exempt real estate loans is the San Francisco Federal Bank rate for the 25th day of the previous month.

A non-exempt real estate loan transaction falls within a particular month based on the date of the earlier of:

- entering into the agreement to make the loan; or
- the funding of the loan if no prior agreement has been entered into for the non-exempt lender.

For example, a private lender signs loan escrow instructions on April 22, agreeing to fund the loan in two weeks, closing in the month of May. The lender is not a party to any prior loan agreement. The borrower's loan application was received by the mortgage loan broker (MLB) in the prior month of March.

The Federal Reserve discount rate applicable to April is 7%, April being the month the first loan agreement was signed – entered into – by all parties. The interest rate agreed to is 12% – the maximum yield permitted without triggering the usury threshold rate controlling non-exempt private lenders who make real estate loans entered into in the month of April (7% plus 5%).

However, on April 25th, the Federal Reserve discount rate is 6%, not the 7% it was on the 25th of March. Thus, the FRBSF rate applicable for the month of May is 6%. Prior to closing in May, the borrower claims his loan interest rate should fall to 11% to reflect the change, because the 12% agreed to in the loan is a usurious yield for loans funded during the month.

However, 7% was the Federal Reserve discount rate in effect on the 25th day of April, the month during which the lender first committed – by signing the loan escrow instructions or other agreement – to make the loan.

Since the commitment to make the loan occurred earlier than the funding, the rate for the month in which the lender's commitment occurred controls – even though the loan was funded in a following month with a different, lower rate for loan commitments made during that month.

*Editor's note – Contingent interest, such as increased interest received on an adjustable rate loan (ARM), is not subject to usury limitations, unless the ARM contained a note rate in excess of usury limitations when originated, or the ARM was designed with an intent to evade usury laws. [**McConnell** v. **Merrill Lynch, Pierce, Fenner & Smith, Inc.** (1978) 21 C3d 365]*

As long as the service performed or the expense incurred was necessary to the origination of the loan, the charges do not add to the lender's yield and is not considered interest. [**Klett** v. **Security Acceptance Co.** (1952) 38 C2d 770]

Examples of services and expenses not included in the interest yield include:

- appraisal, escrow and recording fees [**Ex Parte Fuller** (1940) 15 C2d 425];
- negotiation and brokerage fees paid to a third party [Ex Parte Fuller, *supra*];
- administrative costs, such as foreclosing on the defaulted loan or reconveyancing [**Penziner** v. **West American Finance Company** (1937) 10 C2d 160];
- attorney fees for legal services relating to the loan, such as preparation or review of loan documents [**Murphy** v. **Wilson** (1957) 153 CA2d 132]; and
- late charges due on loan default or prepayment penalties. [**First American Title Insurance & Trust Co.** v. **Cook** (1970) 12 CA3d 592]

### Setting the interest rate

If the proceeds of a loan, including *home equity loans* funded by a non-exempt lender, are earmarked primarily for **personal, family, or household use** by the borrower, then the maximum annual interest rate is 10% per annum, whether secured or unsecured. [Calif. Const. Art. XV §1(1)]

However, loans made to fund the improvement, construction, or **purchase of real estate** when originated by a non-exempt private lender are subject to a different usury threshold rate, which is the greater of:

- 10% per annum; or
- the applicable discount rate of the Federal Reserve Bank of San Francisco (FRBSF), plus 5%.

### Usury law and real estate loans

Two basic classifications of private loan transactions exist relating to interest rates private lenders may charge on real estate loans:

- **brokered** real estate loans; and
- **restricted** or **non-brokered** real estate loans.

**Brokered** real estate loans are exempt from usury restrictions and fall into one of two categories:

- loans **made** by a licensed real estate broker **acting as a principal** for his own account as the private lender who funds the loan; or

- loans **arranged** with private lenders by a licensed real estate broker acting **as an agent** in the loan transaction for compensation.

**Restricted real estate loans** are all loans made by private party lenders which are neither made nor arranged by a broker.

*Editor's note — Private lenders include corporations, limited liability companies and partnerships. These entities would not be exempt from usury limitations unless operating under an exempt classification, such as a personal property broker or real estate broker.*

The most common restricted loan involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured loans.

## Attorneys as brokers

Although attorneys are authorized to perform brokerage activities for compensation in the normal course of the practice of law, an attorney's activities in arranging a loan are not covered by the broker's usury exemption.

For example, a borrower retains an attorney, who is also a licensed real estate broker, to arrange a loan from an unlicensed private lender to be secured by real estate owned by the borrower.

Between the time the attorney/broker is retained by the borrower and the time the loan is arranged, the broker's license held by the attorney expires. The loan transaction closes before the attorney renews his broker's license. The note is payable in monthly installments of interest only, principal being payable as a final/balloon payment on the due date.

After making several interest payments, the borrower defaults and the lender begins foreclosure.

The borrower claims the loan has a usurious rate of interest and is controlled by usury laws since the attorney arranging the loan did not have a valid broker's license on the date the lender committed in writing to make the loan. The lender claims the loan is exempt from usury laws since the attorney is authorized to conduct, for compensation, all activities requiring a broker's license without first obtaining a broker's license.

Can the borrower totally avoid the payment of interest on the attorney-negotiated loan?

Yes! While attorneys may perform acts requiring a broker's license so long as they are rendered in the course of the practice of law, attorneys arranging loans without also being licensed brokers do not bring the private lender loan under the broker's exemption to usury laws. Thus, the loan is usurious since the attorney's broker license formally expired and was invalid on the date the loan was agreed to, barring the private lender's collection of interest from the borrower. All payments now apply to the principal. [**Del Mar** v. **Caspe** (1990) 222 CA3d 1316]

For example, a borrower contacts a private lender for a loan. The individual lending the money is a licensed **California real estate broker**. The lender advances the loan funds and the borrower executes a note in favor of the lender, secured by a trust deed on real estate owned by the borrower. The rate of interest called for in the note exceeds the usury threshold.

The borrower timely repays the note and the lender reconveys the trust deed. The borrower then makes a demand on the lender to return all interest paid, claiming the loan was a usurious transaction.

The lender rejects the interest refund demand, claiming he is a licensed real estate broker and loans made by him from his own funds as a principal are exempt from usury laws.

Is the borrower entitled to a refund of the interest paid?

No! The loan was made by a person who was a licensed California real estate broker when the loan was originated. Thus, the loan is exempt from usury limitations. [**Garcia** v. **Wetzel** (1984) 159 CA3d 1093]

Although loans made or arranged by brokers are exempt from usury limitations, loans made by an unlicensed private lender to a borrower who is a licensed real estate broker are not exempt, unless a third party who is a licensed broker arranged the loan. [**Stoneridge Parkway Partners, LLC** v. **MW Housing Partners III L.P.** (2007) 153 CA4th 1373]

**Exceptions for private parties**

Private party transactions involving the creation of a debt which avoid usury laws break down into two categories:

- **exempt debts**, being debts which involve a loan or a forbearance on a loan and are broker made or arranged; and

- **excluded debts**, being debts which do not involve a loan.

The most familiar of the excluded "non-loan" type debts is the seller carryback.

Carryback notes executed by the buyer in favor of the seller of any real estate, secured or unsecured by the property sold or other property, are not loans of money; they are credit sales, also called installment sales.

As the debt credited in a credit sale, the seller carries back a note, secured or unsecured, at an interest rate which may permissibly be in excess of the usury threshold rate. The rate exceeding the usury law threshold is enforceable since the debt is not a loan. Thus, the carryback note is not subject to usury laws.

**Penalties for usury**

The most common **penalty** suffered by a non-exempt private lender is the forfeiture of **all interest** for the loan. Thus, the lender is only entitled to a return of the principal advanced on the loan. [**Bayne** v. **Jolley** (1964) 227 CA2d 630]

The lender may also have to pay a usury penalty of treble damages. [CC §1916-3]

Treble damages are computed at three times the **total interest paid** by the borrower during the one year period immediately preceding his filing of a suit and the period of litigation until the judgment is awarded.

An award of treble damages as a penalty is normally reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower. [**White** v. **Seitzman** (1964) 230 CA2d 756]

A borrower who knew at all times a loan interest rate was usurious is not likely to be awarded treble damages. Also, a lender who sets a usurious rate in complete ignorance of the illegality of usury would not be additionally penalized with treble damages.

**Usurious loans to a broker/borrower**

Consider an owner of real estate who is a licensed real estate broker and negotiates directly with a private lender to obtain a loan secured by his property.

The interest charged for the loan exceeds the usury threshold rate. The loan is negotiated without the services of another real estate broker arranging the loan.

The lender funds the loan escrow. The trust deed is recorded and the note is delivered to the lender. The borrower is handed the net loan proceeds on closing.

When the note becomes due, the owner/broker tenders payment of an amount equal only to the principal advanced by the lender and demands a reconveyance. The owner claims he owes only the principal borrowed and no interest, since the interest rate is usurious.

The private lender claims the loan transaction is exempt from the interest restrictions of California's usury laws since the borrower is a licensed real estate broker.

Is this loan controlled by usury laws if the owner who borrowed the money is a licensed real estate broker?

Yes! The private lender's rate of return on the loan is limited by usury laws, unless;

- the private lender who **made the loan** is a licensed real estate broker; or
- a real estate broker is paid to **arrange the loan** as an agent of at least one of the parties to the loan. [**Winnett** v. **Roberts** (1986) 179 CA3d 909]

Now, consider a broker who is also a **general partner** in a partnership. The partnership wants to borrow money to improve real estate it owns.

The broker/general partner negotiates with a private non-exempt lender for a loan which is to be secured by real estate owned by the partnership.

The lender funds the loan. The lender receives the partnership's promissory note and trust deed executed in favor of the lender by the general partner on behalf of the partnership. The rate of interest called for in the promissory note exceeds the usury threshold rate.

The partnership timely repays the loan and the lender reconveys the trust deed. The partnership then demands the lender return all interest paid on the loan, claiming the loan was usurious.

Is the partnership entitled to a refund of interest paid on the loan?

Yes! The general partner is not acting in the capacity of a licensed broker when he negotiates a loan on behalf of the partnership, he is acting as its general partner. [**Green** v. **Future Two** (1986) 179 CA3d 738]

*Editor's note — Another California appeals court held in a nearly identical factual situation — tenants in common acting as a group — that the broker acting on behalf of a partnership of which he is a member is considered to be acting for others and thus operating in his licensed capacity. [**Stickel** v. **Harris** (1987) 196 CA3d 575]*

*However, the court in Stickel did not have a firm grasp on brokerage law or the rule that tenants in common constitute a tenancy in partnership. The analysis in the case is faulty as its conclusion relies on the erroneous assumption a broker's license is required for a general partner to deal with real estate owned by the partnership.*

*No broker fee was received or was to be paid to any real estate broker for the act of negotiating the loan for the group. The general partner received only the benefits he would have received as a partner, whether or not this loan was originated. Thus, he did not receive a fee or "arrange" the loan as a broker on behalf of the group as required to qualify it for exemption from usury laws.*

### Agents and usury

Activities of a licensed real estate sales agent are not within the broker's usury exemption, unless the agent is employed by a broker and the agent's level of participation in the transaction constitutes arranging the loan.

For example, an owner wants to refinance a loan secured by real estate he owns. The owner contacts a broker and they discuss acceptable terms for the loan. A loan application is submitted and loan disclosures are made by the broker.

The broker prepares a loan package and submits it to different lenders, but is unable to find a lender to fund the loan. The broker then informs an affiliate with whom he shares office space about the unfunded loan. The affiliate is a licensed real estate agent who is not registered with the DRE as employed by a broker. The agent locates a private lender who funds the loan. The interest rate called for in the note exceeds the usury threshold rate for the loan.

The agent receives a fee paid directly to him by the borrower. The agent does not split the fee with the broker, but he does use a portion of his income to pay joint office expenses.

The owner makes all payments due on the loan and the lender reconveys. The owner then demands a refund of all interest paid, claiming the loan was usurious since it was arranged by a licensed sales agent, not a broker.

Is the owner entitled to a refund of the interest?

No! The initial terms for the loan were established with the borrower by the broker on a loan application. The broker's involvement in packaging the loan transaction and shopping the loan for placement with a private lender is sufficient for the loan to be considered arranged by a broker.

Although the broker did not receive *direct compensation* from the owner, he did receive *indirect compensation* for his involvement since the agent who took a fee contributed to common office expenses. Thus, the loan is exempt from usury limitations. [**Jones** v. **Kallman** (1988) 199 CA3d 131]

Now consider a sales agent who arranges loans for an unlicensed private lender while employed as an agent of a broker. The agent terminates his affiliation with the broker, but does not inform the lender.

Later, a borrower contacts the now **unemployed agent** seeking a loan to be secured by real estate owned by the borrower. The salesman arranges the loan which is funded by the private lender he had contact with while previously employed by a broker.

The borrower executes a note and trust deed in favor of the lender. The interest called for in the note is in exceeds the usury threshold rate. The salesman is paid a fee for arranging the loan.

After making several interest-only payments, the borrower defaults and the lender initiates foreclosure.

The borrower claims he owes no interest to the lender, and all interest paid is to be credited to principal, since the loan was not arranged by a licensed real estate broker and the rate of interest on the loan exceeds the usury threshold rate.

Can the borrower avoid paying any interest on the loan since no broker was involved and the real estate salesman was not working with a broker at any time while arranging the loan?

Yes! For a loan arranged by a salesman to be exempt from usury laws, the salesman must be working with a broker while arranging the loan. Since the salesman was not employed by or affiliated with a broker at any time during his arrangement of the loan. The loan is not exempt from usury laws. [**Dierenfield** v. **Stabile** (1988) 198 CA3d 126]

# Chapter 28 Short payoffs on loans in foreclosure

*This chapter examines the reporting of taxable income and profit on a sale by a seller-in-foreclosure when the price received is less than the balance due on the existing loans and the loans are paid off – satisfied – at a discount.*

***Chapter 28 Outline***

*The discount: income, profit, or loss?*
*The short sale and accompanying discount*
*The discount reduces the homeowner's basis*
*Recourse loans taxed as income after 2012*
*Discount reporting for investor-owners*
*Foreclosure avoids the discount*
*Licensee is still the seller*

***Chapter 28 Terms***

*California anti-deficiency law*
*Deficiency judgment*
*Discharge-of-indebtedness*
*Nonrecourse debt*
*Private mortgage insurance*
*Recourse note*
*Short payoff*

**The discount: income, profit or loss?**

A homeowner, whose residence is now in foreclosure, purchased it for the price of $450,000 with a down payment of $25,000. The remaining $425,000 of the purchase price was funded by a fixed-rate, purchase-assist loan covered by default insurance, called *private mortgage insurance* (PMI).

The homeowner's cost basis in the residence is the $450,000 price he paid, plus transactional costs he incurred to acquire the property. When the property sells, through a broker or by foreclosure, his cost basis will be subtracted from the net sales price, called the *price realized* by the Internal Revenue Service (IRS). The difference between his cost basis and net sales price is the profit or loss he takes whether he resells the property or disposes of it by foreclosure or a deed-in-lieu.

The residence was purchased at the peak of the recent real estate boom. Due to the cyclical decline in real estate values following the excessive, speculator-driven rise, the owner's residence is now worth $250,000. However, while the fixed monthly mortgage payments have remained the same, the owner's combined household income from bonuses and wages has declined. Nearly all of the homeowner's *disposable income* is now consumed by payments on the loan. Thus, the owner can no longer afford to make those payments.

*Editor's note — The same reduction of a household's disposable income occurs for homeowners who experience an increase in the dollar amount of monthly installments when payments for a negative amortization adjustable rate mortgage (ARM) loan (euphemistically called a subprime, toxic, or speculator's loan) reset, while at the same time the homeowner is receiving normal pay raises.*

The loan balance is now $400,000, an amount far greater than the current market value of the property.

The owner lists the residence with a broker in an attempt to sell it and get out from under the excess debt. As agreed with the broker, any purchase agreement entered into will be subject to the lender's acceptance of the net sales proceeds as the payoff amount and full satisfaction of the loan, colorfully called a short sale contingency provision. [**Holmes** v. **Summer** (2010) 188 CA4th 1510; see Form 274 accompanying this chapter; see **first tuesday** Form 150-1]

*Editor's note — Equity purchase (EP) investors who will not be occupying the property-in-foreclosure they purchase in a short sale must use an equity purchase agreement with a short sale provision. [See* ***first tuesday*** *Form 156-1]*

The broker taking the listing understands that, since the fair market value (FMV) of the residence is below the outstanding debt encumbering it, he must negotiate with the lender for a discount on a loan payoff demand, called a *short payoff*. If the lender agrees to accept a short payoff by discounting the amount due to fully satisfy the loan, the property will have gone through what has become known as a "short sale." [Calif. Civil Code § 2943]

The income tax issue confronting the seller when reporting the sale of his principal residence to the IRS and the California Franchise Tax Board (FTB) is whether the amount of the discount is reported:

- as a reduction in his cost basis, which produces either a reduced capital loss or an increase in his home profit; or
- as discharge-of-indebtedness income taxable at ordinary income tax rates.

During tax years 2008-2012, for ;the sale of all properties other than a principal residence, and for all loans other than a purchase-assist or refinance of the purchase-assist debt on a principal residence, the *debt discharged* — the discount — will be subject to ordinary income tax rates unless the loan has nonrecourse status.

On a sale of property after tax year 2013, discharge-of-indebtedness income, whether or not the property is a principal residence, will be subject to regular income tax rates — depending, as always, on the loan's recourse or nonrecourse status. [Calif. Revenue and Taxation Code §17144.5]

**The short sale and accompanying discount**

A *short sale* is a sale of property that:

## SHORTSALE ADDENDUM
Loan Discount Approval

**Prepared by: Agent** ______________________ | **Phone** ______________________
**Broker** ______________________ | **Email** ______________________

**DATE**: _____________, 20______, at ______________________________________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Counteroffer
☐ Escrow Instructions ☐ ______________________________

1.1 ☐ of same date, or dated _____________, 20______, at ____________________________, California,

1.2 entered into by ________________________________________________, as the Buyer, and

1.3 ____________________________________________________________, as the Seller,

1.4 regarding real estate referred to as _______________________________________________
_____________________________________________________________________.

**AGREEMENT:**

In addition to the terms of the above referenced agreement, Buyer and Seller agree to the following:

**2.** Close of escrow under this agreement is conditioned on Seller obtaining payoff demands at a discount from the lienholders of record in full satisfaction of all amounts owed them.

2.1 The discounts are to be amounts which collectively allow Seller to fully perform on this agreement and escrow instructions without the need for escrow to call for funds from Seller to close escrow.

2.2 Seller on opening escrow to promptly request payoff demands from the lienholders, directly or through escrow, and diligently assist each lienholder in their analysis of their discount and processing of their payoff demand by providing them with information and documentation on themselves and this transaction.

**3.** After _____________, 20______, this agreement may be terminated by either Buyer or Seller should Seller be unable to obtain written payoff demands, or consent from the lienholders, to accept Seller's proceeds from this transaction which remain after disbursement of all costs incurred by Seller in the full performance of this agreement and escrow instructions. [See **ft** Form 183]

**4.** Seller may accept backup offers contingent on the cancellation of this agreement.

4.1 If backup offers are received, they will be submitted to the lienholders for payoff demands which may be accepted by the lienholders in lieu of a payoff demand on escrow complying with this agreement.

4.2 Should lienholders submit a written payoff demand in a backup offer acceptable to Seller, Seller may terminate this agreement. [See **ft** Form 183]

**5.** The Seller understands a discount by a lienholder in full satisfaction of the debt owed will likely have consequences on the Seller's creditworthiness and income tax reporting, and other unforseen difficulties, including,

5.1 The delinquencies on payments due the lienholders and the discount allowing for payment of a lesser amount then owed may be reported by the lienholder to credit reporting agencies and adversely affect the Seller in the future.

5.2 The amount of the interest on the discount on the principal will be reported by the lienholder to the IRS as a 1099 Form receipt of income, and depending on the recourse or nonrecourse nature of the debt discounted, or whether secured by the Seller's principal residence, will be reported by the Seller as discharge of indebtedness income, part of the price realized on the sale or a reduction in cost basis.

5.3 ☐ Seller may terminate this agreement within five days of acceptance, based on Seller's reasonable disapproval or the disapproval of tax or legal advisors to the Seller, of the consequences of this discount on Seller's credit or tax reporting, or on liability issues arising due to the discount. [See **ft** Form 183]

| | |
|---|---|
| **I agree to the terms stated above.** | **I agree to the terms stated above.** |
| Date: _____________, 20______ | Date: _____________, 20______ |
| Buyer: ______________________ | Seller: ______________________ |
| Signature: ______________________ | Signature: ______________________ |
| Buyer: ______________________ | Seller: ______________________ |
| Signature: ______________________ | Signature: ______________________ |

**FORM 274** 10-11 

- generates net proceeds for the seller in an amount less than the total amount(s) owed on the loan(s) of record; and

- the lender accepts the *seller's net proceeds* from the sale in full satisfaction of the loan(s).

The difference between the principal balance on the loan and the lesser amount of the net sale proceeds accepted by the lender in exchange for its canceling the trust deed note is called a discount, an arrangement more commonly called a short payoff. This is the amount of the discharge-of-indebtedness at issue.

If the broker is unable to negotiate a **short pay** (discount) with the lender, the seller will make no further payments, if he has not already ceased doing so. Thus, the lender is forced to foreclose and cancel the debt if it fails to arrange a compromise before the foreclosure sale, called a *pre-foreclosure workout*, loan modification, cramdown, or short pay.

Most lenders require the seller to default on payments for at least three months (so they pay the penalty of a ding to their FICO score) before they will consider a discounted payoff to accommodate a short sale. A default in payments is the legal step taken by the owner to exercise the "*put option*" he holds, a contract right inherent in all trust deed loans. The **put option** allows the owner to force the lender to buy the property through the foreclosure process (or consider a compromise) should the lender refuse a deed-in-lieu, loan cramdown, etc. [See **first tuesday** Form 406 accompanying this chapter]

The broker's ability to successfully negotiate a short payoff with the lender depends in part on the type of loan that encumbers the seller's property.

If the loan is an FHA-insured loan on an owner-occupied, single family residence, the lender may only accept a short payoff if the owner qualifies for FHA pre-foreclosure sale treatment. To qualify, the homeowner must be in default on at least three months' payments, in addition to meeting other financial ability (hardship) requirements. [HUD Mortgagee Letter 94-45]

Likewise, if the loan is a conventional loan covered by PMI, the lender's willingness to negotiate a short pay will be influenced by the lender's ability to settle their claim with the private mortgage insurer to cover the lender's loss on the **short payoff**. Much documentation on the seller's solvency (hardship) and the property's value (by a comparable market analysis) must be produced for analysis by the lender and PMI carrier – all of which is for naught if the deal is strategic or deliberate for purposes of getting rid of the property and its excess debt. [See **first tuesday** Form 318]

### The discount reduces the homeowner's basis

Consider the seller-in-foreclosure who owes $400,000 on the purchase-assist trust deed loan encumbering his residence or on the refinance of a purchase-assist loan. The property's FMV is $250,000. The original purchase price, and thus the seller's cost basis, is $450,000 (plus closing costs).

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

# DEED-IN-LIEU OF FORECLOSURE

**Prepared by: Agent** ____________ **Phone** ____________
**Broker** ____________ **Email** ____________

**DATE:** ________, 20____, at ______________________, California.

**1.** I/We, ______________________________,

hereby quitclaim to ______________________________

1.1 all of my rights, title and interest in the real property situated in ____________ County, California, referred to as ______________________________

______________________________.

**2.** This deed is an absolute conveyance in consideration for ______________________________ and

2.1 the cancellation and release of all rights and obligations arising from the document

2.2 entitled ______________________, dated ____________,

2.3 entered into by ______________________, as the ____________, and

2.4 ______________________, as the ____________.

**3.** Grantor declares that this conveyance was freely and fairly made upon the consideration listed above, and no agreements exist, oral or written, except as contained in this deed, with respect to the described property.

Date: ________, 20____ ______________________________
(Print Name) (Signature)

Date: ________, 20____ ______________________________
(Print Name) (Signature)

STATE OF CALIFORNIA
COUNTY OF______________________
On ______________________ before me,
______________________________
(Name and title of officer)
personally appeared ______________________________
______________________________,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ______________________________
(Signature of notary public)

(This area for official notarial seal)

**FORM 406** 03-11 

The seller has received information by an advertisement that implies he will incur taxes at ordinary income tax rates on any discount taken by the lender on the sale or foreclosure of the property, called *discharge-of-indebtedness income* by the IRS.

The ad then claims the homeowner will avoid the tax liability resulting from income generated by the discount on a short sale if title to the property is transferred to the person offering the service, called a coordinator.

The coordinator offers to take title to the real estate subject to the foreclosure and either:

- complete or arrange a short sale of the property himself; or
- allow the lender to foreclose against the coordinator's title for nonpayment of installments.

Does the advertisement correctly represent the homeowner's tax reporting and tax liability exposure from a short sale handled by whomever takes title subject to the loan?

No! The short sale of an owner-occupied one-to-four unit residential property encumbered by a purchase-assist loan, improvement loan or refinance on a loan, called a nonrecourse loan under *California anti-deficiency law*, does not trigger IRS reporting of ordinary income by the seller for the discounted and discharged portion of the loan.

For reporting discounts on purchase-assist and improvement (nonrecourse) loans, the owner closing a sale of his principal residence after January 1, 2007 and on or before December 31, 2012 no longer adds the amount of the lender's discount to the price paid by the buyer to set the price realized on the sale — as has been the rule since the 1930s.

Instead, the discount on purchase-assist and home improvement loans, in this case $150,000, is now deducted from the seller's cost basis ($450,000) to establish an adjusted cost basis of $300,000. Thus, the sale produces a capital loss of $50,000 — the price realized ($250,000) minus the owner's adjusted cost basis ($300,000). This capital loss is a personal loss (principal residence) and cannot be used (written off) to reduce taxable income.

This tax result is congruous with the prior tax reporting rule on a short sale: the discount is not to be reported as **discharge-of-indebtedness** income, and instead produces a "personal loss" on the sale. [Internal Revenue Code §108(e)]

Anti-deficiency bars first trust deed recovery on short sales of one-to-four residential units

When a homeowner sells a one-to-four unit residential property encumbered by a first trust deed in an amount exceeding the net proceeds from the sale and the lender accepts the sales proceeds in exchange for reconveyance of their trust deed (commonly called a short sale), the difference (discount) is discharged and the lender barred from collecting any deficiency. [Calif. Code of Civil Procedure 580e]

However, this **anti-deficiency protection** does not protect a homeowner from liability for his fraud in the sale or waste to the property securing the first trust deed.

*Editor's note — While this increased anti-deficiency protection may seem like a victory for the underwater homeowner, it does not provide anti-deficiency protection for home equity loans when the first forecloses and wipes out the second trust deed — the primary source of deficiency judgments in California.*

The legislature did not define dwelling as limited to only owner-occupied single-family residences, as they did in Code of Civil Procedure §580b for purchase-assist loans to acquire a primary residence the borrower will occupy. Hence, this anti-deficiency legislation applies to all one to four residential units, owner occupied or a rental, barring recovery of any deficiency in the value of the property to fully justify the loan on the discount pay off, whether the loan is a purchase-assist loan or a refinance. [CCP §580e]

**Recourse loans taxed as income after 2012**

The preferential federal tax reporting currently available for a discounted payoff of both nonrecourse and recourse loans based on the amount of purchase-assist and improvement loans will not be allowed on short sales of real estate involving recourse loans after December 31, 2012. No portion of the discount on a recourse loan will be subtracted from the owner's cost basis nor be included in the price realized.

*Editor's note — This lenient tax reporting originally applied to any discharge-of-indebtedness income forgiven in calendar years 2007 through 2009, but was extended through 2012 by the Emergency Economic Stabilization Act of 2008 and by California Senate Bill 401. [IRC §108(h); Rev & TC §17144.5]*

Instead, the recourse loan discount will be reported to the IRS after 2012 as gross income, as it was reported before January 1, 2007. Thus, the owner will not even be entitled to the 15% (capital gain) to 25% (recapture of depreciation gains) tax rate on profit for that portion of the discount representing a portion of the original purchase-assist or improvement loans. Instead, the full discount will be taxed at ordinary income rates (10% to 35% in 2008).

When a short sale occurs after December 31, 2012 on real estate encumbered by a recourse loan, the seller will incur a tax liability at ordinary income rates on the discount reported by the lender on an IRS 1099 Form, which is labelled discharge-of-indebtedness income. Conversely, when a *nonrecourse debt* is discounted on a short sale, the seller's tax liability, if any, will still be on any profit taken on the price realized. That price realized will be set as the principal amount of the nonrecourse loan without concern for the discount or the property's FMV. This rule currently applies to property other than the principal residence. [Revenue Regulations §1.1001-2(a)(2)]

For example, an owner's property is encumbered by a $400,000 trust deed loan. The loan is a recourse debt that exposes the owner to a deficiency judgment if the value of the secured real estate becomes less than the amount of the debt. The real estate is now worth only $250,000, $150,000 less than the loan amount, which is the deficiency. However, the owner's cost basis in the real estate is $450,000.

The owner sells the real estate on a short sale. The net amount the buyer pays for the real estate is $250,000. The lender accepts the net proceeds from the sale as a short payoff and in full satisfaction of the **recourse note**. The remaining unpaid balance of $150,000, the discount, is forgiven by cancellation of the note since the lender does not judicially foreclose as is first required to pursue a *deficiency judgment* against the borrower. However, the lender must report the discount to the IRS.

The owner's tax consequences, calculated based on both the sale of the property and the discount of the recourse loan, include:

- a capital loss of $200,000 ($250,000 price received from the buyer minus the $450,000 owner's cost basis); and

- a **discharge-of-indebtedness** income of $150,000 ($400,000 loan amount minus the $250,000 price realized and paid to the lender), reported as ordinary income.

Again, since the owner's cost basis is greater than the sales price and the property sold is the owner's principal residence, the resulting capital loss is a personal loss. Since it is not a loss on the sale of a property that falls within an income category due to its personal nature, it cannot be written off to offset the taxation of other income — specifically to offset and reduce the discharge-of-indebtedness income. Not so for business use or income/investment property short sales.

After December 31, 2012, a discount on the payoff of a recourse loan (refinancing) encumbering a principal residence will result in taxable discharge-of-indebtedness income. Ironically, this income produced by the short sale of the principal residence cannot be offset by the capital loss produced by the same principal residence on the sale. The loss is classified as personal. [**Vukasovich** v. **Commissioner of Internal Revenue** (9th Cir. 1986) 790 F2d 1409; IRC §165(c)]

**Discount reporting for investor-owners**

The new tax reporting rules in effect until December 31, 2012 only apply to the short sale of the owner's principal residence. Discount reporting for the short sale of investor-owned property is still controlled by treasury regulations.

For an investor, the debt discharged by a discount of a loan paid off on a short sale of property other than the investor's principal residence will be a recourse loan producing discharge-of-indebtedness income, unless the investor:

- assumed a **nonrecourse loan**;

- executed a carryback note secured by the property when acquired; or

- executed a note containing an exculpatory clause releasing the investor from any personal liability.

When the discount is on any type of nonrecourse loan, the investor's discharged debt will be added to the price the buyer pays for the property, setting a price realized at the amount due the lender. Thus, the discount becomes a profit taxed at capital gains rates, not income taxed at personal income rates. [Rev. Reg. §1.1001-2(a)(2)]

**Foreclosure avoids the discount**

An alternative of great importance to a seller faced with discharge-of-indebtedness income on a recourse loan now or after 2012 is to avoid a short sale, and thus a short payoff, by forcing the lender to foreclose and acquire the property. Lenders nearly always foreclose by a trustee's sale. If they do not, further analysis by the owner is needed since he will be confronted with a judicial foreclosure situation.

Further, lenders at a trustee's sale usually bid on the property for the amount of all monies owed them, regardless of the property's present market value. Thus, they have been fully satisfied by their bid without a discount or uncollectible amount remaining due from the owner. Thus, there is no discharge-of-indebtedness income.

Listing brokers, take note. You are duty-bound to care for and protect your client-seller from adverse consequences known to the broker or his agent.

# Chapter 29 — Commingling rental losses with other income

*This chapter reviews the use of rental operating losses to offset business income, investment income and profits.*

***Chapter 29 Outline***

*The part-time landlord*
*Reporting rental operating loss*
*Real estate related business*
*Time spent serving others*
*The landlord's material participation*
*Material participation must be active*
*The 500-hour landlord*
*The over-100-hour landlord*
*Five out of ten*
*The mutually exclusive $25,000 deduction*

***Chapter 29 Terms***

| | |
|---|---|
| *Active participation* | *Services rendered* |
| *Occupancy rule* | *Suspended losses* |
| *Owner-operator* | *Separately satisfy* |
| *Reportable operating losses* | |

**The part-time landlord**

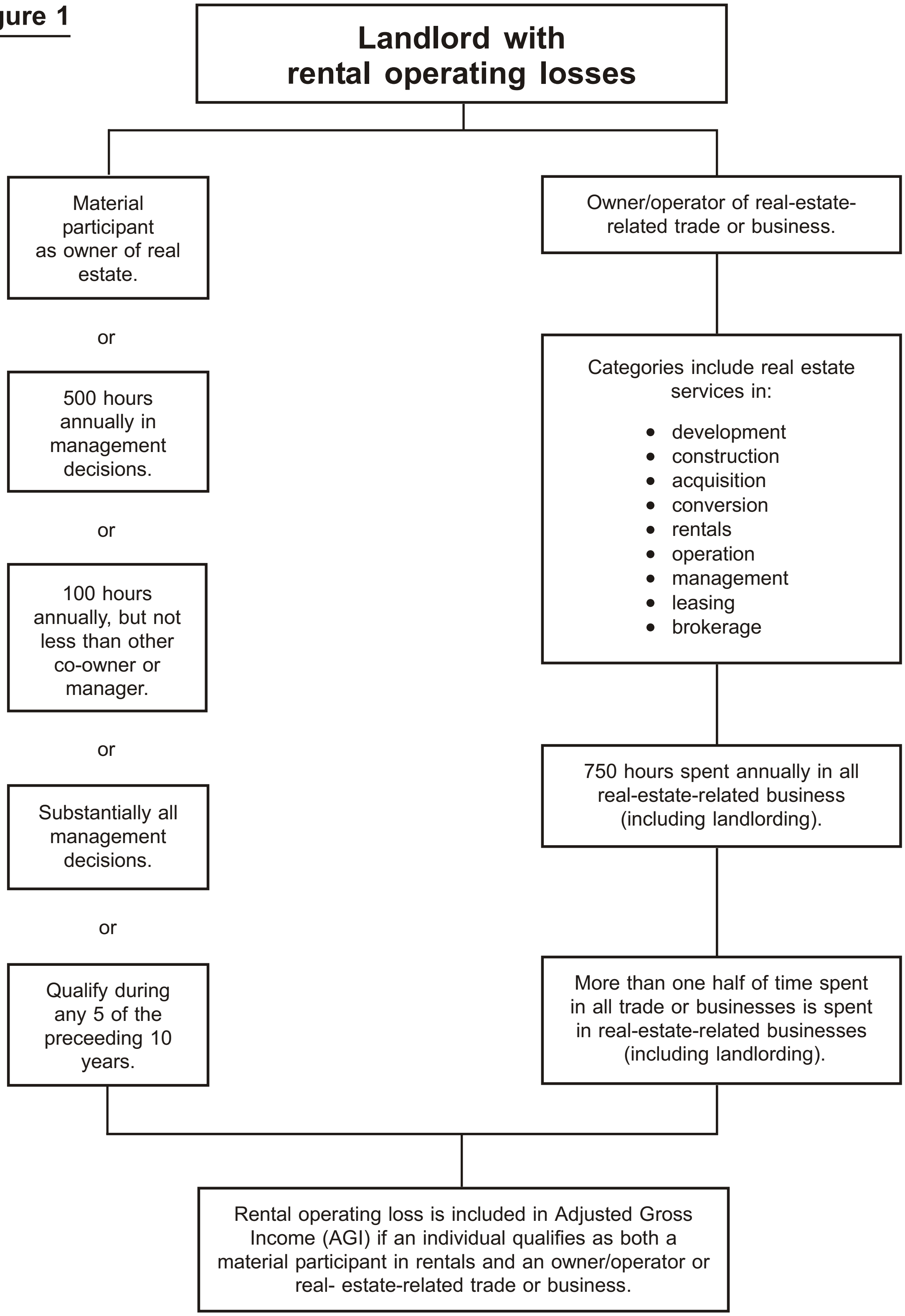
A real estate broker owns rental properties and a brokerage business. The broker works 30 hours a week in his brokerage business, acting on behalf of clients. He spends an average of 10 hours a week on management, care and maintenance of his own rentals.

In managing his rentals, the broker interviews prospective tenants, checks their credit and prior rental history and prepares and signs all leases. He also collects rents and arranges for all repairs and maintenance.

At the end of the year, the broker has a reportable net operating loss from his rental activities. Can the broker use the loss from his rentals to offset any income from his brokerage business?

Yes! An owner who *renders services* acting for his own account as a landlord, investor, developer or builder, or acting on behalf of others as a real estate licensee, qualifies to offset his business income and investment profits with rental operating losses.

**Figure 1**


Landlord with rental operating losses
Material participant as owner of real estate.
or
500 hours annually in management decisions.
or
100 hours annually, but not less than other co-owner or manager.
or
Substantially all management decisions.
or
Qualify during any 5 of the preceeding 10 years.
Owner/operator of real-estate-related trade or business.
Categories include real estate services in:
• development
• construction
• acquisition
• conversion
• rentals
• operation
• management
• leasing
• brokerage
750 hours spent annually in all real-estate-related business (including landlording).
More than one half of time spent in all trade or businesses is spent in real-estate-related businesses (including landlording).
Rental operating loss is included in Adjusted Gross Income (AGI) if an individual qualifies as both a material participant in rentals and an owner/operator or real- estate-related trade or business.

This offsetting of income is called an adjustment, to reduce the owner's adjusted gross income (AGI). [Internal Revenue Code §469]

**Reporting rental operating loss**

All income, profit or loss from residential and nonresidential rental properties with an average occupancy of more than 30 days is reported by the owner in the passive income category, separate from income in the trade/business income category, such as brokerage income, or the investment/portfolio income category, such as carryback notes or land held for profit on a resale.

*Reportable operating losses* from a single rental property first offset operating income and sales profits from other rentals properties of the owner reported in the passive income category. Any losses remaining after offsetting income and losses between all the rental properties held by the owner then spill over to offset passive category income from other sources, such as income received as a member in a partnership, limited liability company (LLC) or S corporation which owns a business operated by someone other than the owner of the rentals.

Unless allowed to use the rental losses to offset income generated by the owner under business or portfolio income categories, rental operating losses remaining after offsetting income and profits within the passive category are reallocated back to the rental properties that generated the operating losses, not back to those with an operating net income. The reallocated losses are accounted for as *suspended losses*.

However, the rental owner may annually qualify to use the rental losses as either:

- an adjustment to reduce the AGI; or
- a deduction from the AGI of up to $25,000 annually.

Consider a married couple who incurs a reportable operating loss on their rental property, comprised of both residential and nonresidential property.

Neither spouse is in a business related to real estate. One spouse is a doctor and manages the couple's rentals. The other spouse is not involved in any aspect of the rentals.

Because the couple's AGI exceeds $150,000, the couple does not qualify to *deduct* any part of their loss from their AGI under the limited $25,000 annual operating loss deduction rules. If they qualified, the loss would reduce the taxable income on their joint return. [IRC §469(i)]

However, either spouse, independent of the other, can qualify the rental operating loss as an adjustment in order to reduce their AGI. [IRC §469(c)(7)(B)]

To qualify **rental operating losses** as an AGI adjustment (not a deduction), the unemployed spouse must assume all duties as the manager of the couple's rentals. As manager, the spouse must spend sufficient time to qualify as both:

- an owner-operator of a real estate related trade or business; and

- a material participant in the ownership of the rentals. [IRC §469(c)(7)(B)]

**Real estate related business**

The real estate related trade or business of a landlord, acting on his own behalf or representing others as a broker or builder, includes real estate activities such as:

- development or redevelopment;
- construction or reconstruction;
- acquisition;
- conversion;
- renting;
- operation;
- management;
- leasing; or
- brokerage. [IRC §469(c)(7)(C)]

For a landlord to qualify as an *owner-operator* of a real estate related trade or business, two criteria must be met:

- the business must render professional real estate **services**, or **manage**, **invest** in or **develop** real estate for their own accounts; and
- the landlord must spend a minimum amount of **time** in the real estate related businesses. [See Figure 1]

Consider a landlord who spends sufficient time **acquiring**, **managing** or **leasing** his own rentals. He qualifies as working in a real estate related business, even though his income or losses from rental operations is always reported as passive category rental income and cannot be classified as trade or business category income.

When the landlord's business and rental activities qualify as real estate related business activity, adjustments to the AGI may then include his **rental operating losses**, which are otherwise excluded. However, rental operations alone qualify as a real estate related trade or business if the landlord spends sufficient time on his duties as a landlord. [See **first tuesday** Form 351]

Thus, for the landlord to offset business or investment income with his rental operating losses, he must annually spend a minimum amount of time rendering real estate services for others and for himself, as follows:

- more than **half of his time** spent rendering services must be in real estate related trades or businesses (landlording/developing, or brokerage); and
- more than **750 hours of the entire year** must be spent in real estate related trades or businesses (a 15-hour weekly average). [IRC §469(c)(7)(B)]

To determine whether the individual spends sufficient time in real estate related trades or businesses, time spent in all his real estate related trades or businesses and landlording is combined.

**Time spent serving others**

Consider a practicing doctor who is married and owns several rentals. The doctor averages 30 hours weekly as a physician and 15 hours weekly tending to the rental properties. The doctor's spouse is uninvolved in the acquisition and management of the rentals.

While the doctor has an annual reportable income from his practice, the rentals are highly leveraged and produce an overall reportable operating loss.

Does the doctor qualify as an owner-operator of a real estate related trade or business to offset other income with the rental operating loss?

No! While the doctor spent 750 hours during the year (15 hours weekly) actively participating in a real estate related trade or business (the ownership of rentals), the amount of time spent as a landlord was not more than half of the total time spent tending to both his rentals and his patients, called **rendering services**. [IRC §469(c)(7)(B)]

Also, time spent by the doctor managing his portfolio category investment (trust deed notes and land held for profit) does not qualify as professional services rendered in a real estate related trade or business.

**The landlord's material participation**

Now consider a practicing doctor who is married and owns several rentals that are community property. The doctor's spouse works more than 15 hours weekly acquiring and managing the rentals. The spouse has no other job and the couple files a joint return.

Does the couple qualify as owner-operators in a real estate related trade or business because of the spouse's involvement in the rental activity?

Yes! For married couples filing jointly, one spouse can *separately satisfy* the requirements to **qualify the couple** as owner-operators of a real estate related trade or business. [IRC §469(c)(7)(B)]

Here, the amount of time the spouse spent operating the couple's rentals was sufficient to qualify the rentals as a real estate related trade or business. The spouse qualified because:

- more than half of the total time providing services of all types was spent in a real estate related trade or business (the rentals); and

- more than 750 hours of the year were spent in a real estate related trade or business (the ownership of rentals). [IRC §469(c)(7)(B)]

Thus, the combination of the couple's joint ownership and rental activity qualifies them as rendering services in a real estate related trade or business.

In order to use the couple's rental operating losses to offset other income, the managing spouse must demonstrate a *material participation* as a landlord in the rental operations, in addition to ownership and services rendered.

To qualify as a **material participant**, the managing spouse must meet one of the following criteria:

- Time spent handling the rentals exceeds 500 hours annually (about 10 hours weekly);

- Time spent handling the rentals exceeds 100 hours annually (about 2 hours weekly), but is not less than the amount of time spent by any other co-owner or manager;

- The managing spouse's work includes substantially all management of the rentals; or

- Either spouse individually qualified during any five of the preceding 10 years. [26 Code of Federal Regulations §1.469-5T(a)]

In this case, since the managing spouse makes all decisions in connection with the management of the rentals, thus satisfying one of the criteria, any rental operating losses can be used to adjust the couple's AGI.

**Material participation must be active**

Consider an income property owner, whose primary occupation is not a real estate related business. The property owner participates in the operation of his rental property, and also spends time "on call" during the hours when he is not specifically operating his rental property.

The property owner keeps a log of his time spent operating his rentals, totaling over 750 hours for the year, including "on call" time.

Is the property owner entitled to report his rental income losses under the passive income category to offset other income as an adjustment to his AGI?

No! "On call" activity does not qualify as material participation in the operation of rental property, and the property owner therefore does not have the 750 required hours to be qualified as a material participant and write off rental losses as a reduction in AGI. [**In re Moss** (2010) 135 TC 18]

**The 500-hour landlord**

Consider a real estate broker who works full time at his brokerage business and owns rental properties as a co-owner with other investors.

The broker reviews and approves tenants and leases, and collects and deposits rents. He spends an average of at least 10 hours weekly managing the rentals. One of the investors spends more time than the broker does in the management of the rentals.

The rentals generate a reportable operating loss for the year, due to interest deductions, depreciation schedules and vacant units.

Can the broker write off his share of the rental operating loss to offset his brokerage income even though his co-owner is more involved in management than he is?

Yes! First, as a broker operating a real estate brokerage service, he qualifies as rendering services in a real estate related business. Secondly, the broker qualifies as a **material participant** in his rentals since he spends more than 500 hours of the year on the management of the units. [26 CFR §1.469-5T(a)(1)]

Thus, he is allowed to use the rental losses to offset his brokerage income and lower his AGI, called an adjustment, not a deduction. The co-owner, for the same reason, also qualifies to write off the rental loss against other income.

**The over-100-hour landlord**

Now consider a licensed sales agent who owns rentals and works 40 hours weekly as an agent for a real estate broker. The agent's income is reported under his independent contractor tax status.

The agent handles all aspects of management and operation of his rentals and arranges for their maintenance and repair. He spends an average of six hours weekly on his rentals.

The agent also employs an on-site resident manager who averages less than six hours a week deciding what repairs to make and which potential tenants qualify to lease.

Can the agent write off his rental operating losses against his real estate sales income?

Yes! The agent's real estate employment as an independent contractor to a broker qualifies as rendering services in a real estate related business. Also, the agent's landlording activities meet the standard for material participation since he works more than 100 hours annually on his rentals and his resident manager does not spend more hours managing the rentals than he does. [26 CFR §1.469-5T(a)(3); IRC §469(c)(7)(C)]

Now consider a broker who owns a brokerage business and income-producing real estate. The broker works approximately 40 hours weekly on his brokerage business.

The broker's time spent on the management and maintenance of the duplex is relatively minimal, averaging approximately six hours monthly. The broker handles all aspects of the management and operation of the rental, except for the maintenance and repair of the units, which he arranges to be done by a handyman. The handyman works more hours monthly in repairing and maintaining the rental than the broker does in managing the rental.

Can the broker use any rental operating loss to offset other income from his brokerage business?

Yes! The broker can use any rental operating loss to offset other income as an adjustment to his AGI since the broker performs substantially all of the management of the units. Maintenance and repairs, which the handyman performs, are not management activities. [26 CFR §1.469-5T(a)(2)]

**Five out of ten**

Consider a developer who owns several rentals. In most years, the developer works an average of 25 hours weekly on his development projects and 15 hours weekly managing his rentals.

The developer was qualified as a material participant in his rentals for the last four years, was not qualified for one year before that, and was qualified for the two years prior to that — a total of six out of the last ten years.

In the current year, sales of new houses were up. Consequently, the developer worked 40 hours (or more) weekly on his development business and hired a property manager to operate the rentals, leaving the developer only marginally involved in the rentals. His development business showed a reportable income this year, but his rentals had a reportable operating loss.

Can the developer use his rental operating loss as an offset against his business income?

Yes! Although the developer is not a material participant in the day-to-day decision-making process of managing his rentals this year, he qualified as a material participant in at least five of the last ten years. [26 CFR §1.469-5T(a)(5)]

**The mutually exclusive $25,000 deduction**

To be classified as passive income category property, rentals only need to be occupied by tenants for an average of more than 30 days. The over 30 days' *occupancy rule*, together with the owner's active participation in its operations, locks reporting of a property's income, expenses, interest and depreciation in the passive income category as rental income. [See IRS Form 1040, Schedule E]

Rental operating losses remaining after the offset of other rental and passive business income or profits can be deducted from the landlord's AGI in amounts of up to $25,000 a year to establish the landlord's taxable income if, among other tests, the landlord qualifies as an active participant in his rental operations.

To be "active" means a landlord holds primary responsibility for the maintenance and management of the real estate under leases entered into with tenants, even though a broker may exclusively handle all the rental activities as the agent of the landlord under a property management agreement.

The $25,000 rental operating loss deduction is available for those landlords who do not qualify as material participants for the rental operating loss adjustment to the AGI.

Obviously, the $25,000 loss deduction from the AGI will not be needed if a landlord's time and effort operating his rentals qualifies any rental operating losses as an adjustment to establish his AGI rather than a deduction.

# Chapter 30 — Home office costs expensed

*This chapter presents the home office brokerage activities needed to establish a home office for expensing costs.*

***Chapter 30 Outline***

*The costs and uses that qualify*
*Brokers and sales agents*
*Indirect expenses*
*Exclusive use*
*Regular use*
*Qualifying uses*
*Principal place of business*
*Two offices — one for the public*
*Two offices — main office is downtown*
*Sales agents and the home office*
*Limitations on deductions*

***Chapter 30 Terms***

| | |
|---|---|
| *Direct expenses* | *Principal place of business* |
| *Exclusive use* | *Qualifying uses* |
| *Home office deduction* | *Regular use* |
| *Indirect expenses* | |

**The costs and uses that qualify**

Real estate licensees who work out of their homes, whether rented or owned, may qualify to expense the costs of maintaining the home office as an offset against their brokerage income.

To qualify for the *home office deduction*:

- a portion of the home must be used **exclusively** and **regularly** for the licensee's brokerage business;

- the expenses may be **direct** or **indirect**; and

- the use of the home office must meet one of three **business activity standards**.

**Brokers and sales agents**

Taxwise, real estate brokers and sales agents both report to state and federal taxing authorities as self-employed individuals, also called *independent contractors*, if:

- they are licensed as a broker or sales agent;
- all compensation they receive is substantially based on completed transactions, such as sales and most other brokerage services (called **contingency fees**), rather than an hourly wage or salary; and
- a sales agent has a written agreement with his employing broker to consider the sales agent an independent contractor for income tax purposes. [Internal Revenue Code §3508(b)(1); see Figure 1, **first tuesday** Form 506]

Both brokers and sales agents employed as independent contractors qualify for the home office deduction under the same rules. If the licensee qualifies for the home office deduction, the deductible **home office expenses** include:

- the *direct expenses* attributable to the home office **area used exclusively** in the business; and
- the *indirect expenses*, which are limited in amount to the **percentage of the area** in the residence that is used as the home office.

**Direct expenses**, deductible as a brokerage business expense, include the cost of decorating and repairs made in the portion of the residence exclusively used as the home office.

The entire amount of direct expenses is deductible from business income without allocation for the personal use of the remaining space in the residence.

**Indirect expenses**

**Indirect expenses** are costs incurred in the upkeep and operation of the licensee's entire residence, including:

- rent paid as a tenant;
- mortgage interest;
- real estate taxes;
- home insurance;
- utilities; and
- maintenance. [Internal Revenue Service Publication 587]

## Figure 1

**INDEPENDENT CONTRACTOR EMPLOYMENT AGREEMENT**

For Sales Agents and Associated Brokers

**Prepared by: Agent** ______________________ **Phone** ____________________
**Broker** ______________________ **Email** ____________________

**DATE:**____________, 20_____, at ______________________________________________, California.

*Items left blank or unchecked are not applicable*

**FACTS:**

**1.** Broker hereby employs Agent as a real estate sales agent or broker-associate, until terminated by either party, on the following terms.
1.1 Agent to be treated as an independent contractor for tax purposes.

**2. AGENT** agrees:
2.1 To maintain a real estate license in the State of California.
2.2 To provide brokerage services only on behalf of Broker.
2.3 To follow the Broker's policy manual and any directions orally given by Broker.
2.4 To use only those real estate forms authorized by Broker.
2.5 To make complete and immediate disclosure to Broker of any correspondence or document made or received.
2.6 To immediately deliver and account to Broker for funds received by Agent in the course of this employment.
2.7 To participate in educational programs and meetings specified by Broker.
2.8 To visually inspect the physical conditions of any property to be sold or bought for clients.
2.9 To obligate Broker to no agreement without Broker's prior consent.
2.10 To expose Broker to no liability to any third party without Broker's prior consent.
2.11 To furnish his own transportation and carry a liability and property damage insurance policy in an amount satisfactory to Broker with a policy rider naming Broker as a co-insured.
2.12 To faithfully adhere to the Real Estate Law of the State of California.
2.13 To file and pay quarterly estimated taxes and self-employment taxes.
2.14 To contribute to the defense and settlement of litigation arising out of transactions in which Agent was to or shared fees, in an amount equal to Agent's percentage share of the fees.
2.15 To join and pay fees for membership to professional organizations in which broker is a member.
2.16 Other ________________________________________________

**3. BROKER** agrees:
3.1 To maintain a real estate Broker's license in the State of California.
3.2 To maintain office(s) with proper facilities to operate a general real estate brokerage business.
3.3 To maintain membership in the following professional organization(s):
☐ Multiple Listing Service
☐ Local branch of the California Association of Realtors and National Association of Realtors
☐ ________________________________________________
3.4 To maintain listings.
3.5 To provide advertising approved by Broker.
3.6 To provide worker's compensation insurance for Agent.
3.7 To file informational tax returns on Agent's fee or other compensation, under State and Federal Tax regulations.
3.8 To pay Agent as specified in the Broker's fee schedule at section 5.
3.9 To maintain the following insurance coverage's for Agent:
☐ Errors and Omissions ☐ Life
☐ Health ☐ Dental
3.10 ☐ ________________________________________________

**4. General Provisions:**
4.1 Agent has the right to purchase any properties listed by Broker on full disclosure to the Seller of the Agent's activity as a principal, and without diminution of fees to the Broker.
4.2 Agent is authorized to enter into any documents required to perform any of the services referenced in this agreement.
4.3 Broker has the right to reject any listing or retainer agreement obtained by Agent.
4.4 Broker to determine whether any litigation or dispute involving the Broker, or his business and third parties, arising from Agent's activities, shall be prosecuted, defended or settled.
4.5 Arbitration: Any dispute between the Agent and the Broker or with any other Agent employed by Broker that cannot be settled by the Broker, or resolved by the State Labor Commission or by non-binding mediation, shall be arbitrated under the rules of the American Arbitration Association.

*— — — PAGE ONE OF TWO — FORM 506 — — —*

*— — — PAGE TWO OF TWO — FORM 506 — — —*

4.6 ☐ **See addendum for additional provisions.**

**5. Broker's Fee Schedule and Charges:**
5.1 Broker is to pay Agent a fee for participating in a sales transaction evidenced by a purchase agreement which confirms the Agent is acting as an agent for Broker and Broker receives a brokerage fee on the transaction.
5.2 The amount of fee due Agent is _____% of the funds remaining from the brokerage fee received by Broker under section 5.1 after first deducting the following amounts:
a. Payment to other brokerage offices of sums due them for their participation in the transaction;
b. Payment to Broker's franchisor of the fee due the franchisor from the transaction;
c. Payment to Broker of one-half of the then remaining funds if another Agent of Broker is entitled to a fee for negotiating the other end of the transaction;
d. Other deductions ________________________________________________.
5.3 From each fee due Agent and before disbursement, Broker will deduct the following amounts and any amounts otherwise due Broker from the Agent:
a. An advertising or promo charge of $____________.
b. An errors and omissions insurance coverage charge of $____________.
c. A charge of $____________ for ________________________________________.
d. Disbursement to another Agent of Broker, transaction coordinator or finder with whom Agent agreed to share the fee due under section 5.2.
5.4 The percentage participation by Agent in the funds remaining under section 5.2 is adjusted to _____% on the following event ________________________________________________
and will apply until ____________________.
5.5 Agent is to pay Broker, on the first of each month of employment, a desk fee of $____________.
5.6 Any expenses incurred by Broker in a transaction negotiated by Agent, such as travel expenses, meals, attorney fees, printing, listing service fees, etc., shall be deducted from the fee due Agent.
5.7 If all or part of the fee is received in property other than cash, Agent is to obtain Broker's prior approval. In this event, Broker shall make one of the following determinations for disposition of the property:
a. Divide the property between Broker and Agent in kind, based on the fee schedule; or
b. Pay Agent his dollar share of the fee in cash; or
c. Retain the property in the names of Broker and Agent, or their trustee, and thereafter dispose of it when on terms Broker and Agent agree to on its acquisition. Any ownership income and expenses shall be shared between Broker and Agent in proportion to their share of ownership.
5.8 On termination, Agent to be paid as follows:
a. Closed Transactions: Agent shall receive his share of fees on all transactions which are closed before termination.
b. Pending Transactions: Agent shall receive his share of fees on all pending transactions which close after termination.
c. Unexpired Listings and Retainers: Agent shall receive his share of fees if the client enters into a transaction during the written listing or retainer period. Agent shall not earn a fee under any extension of the listing or retainer obtained after termination.
d. Fee Limitation: If on termination Agent has pending transactions commisionable under section 5.1 or unexpired listings or retainers procured by Agent which require further services normally rendered by Agent, Broker shall direct another employed Agent or himself to perform these services. For these services after termination, a reasonable share of the fee shall be deducted from the fee due Agent.

| **I agree to render services on the terms stated above.** | **I agree to employ Agent on the terms stated above.** |
|---|---|
| Date: ____________, 20_____ | Date: ____________, 20_____ |
| Agent's Name: ______________________ | Broker's Name: ______________________ |
| Agent's Signature: ______________________ | Broker's Signature: ______________________ |
| Address: ______________________ | Address: ______________________ |
| Phone: ______________________ | Phone: ______________________ |
| Cell: ______________________ | Cell: ______________________ |
| Email: ______________________ | Email: ______________________ |

**FORM 506** 06-12 

The portion of indirect expenses deductible as a business expense is equal to the percentage of the residence used as the home office.

For example, a broker exclusively uses 300 square feet of his residence as his home office. The total area of the residence is 1,800 square feet. Thus, the broker's home office is 16.7% of the total square footage of the residence.

The broker's indirect annual expenses — incurred as ownership and operating expenses on the entire residence — include:

- $15,000 in mortgage interest;
- $2,000 in real estate taxes;
- $3,600 in utility payments; and
- $900 in insurance costs.

The total amount of indirect expenses is $21,500.

The broker can write off $3,590.50 as indirect business expenses, 16.7% of the $21,500 residence expenses. [Prop. Rev. Regs. §1.280A-2(i)(7)]

In lieu of ownership expenses, if the broker is a tenant in a home or apartment that he uses in part for his office, he can write off a pro rata amount of the rent as a business expense. [**Visin** v. **Commissioner** (2003) 86 TCM 279]

The broker also spent $1,200 for pool and landscape maintenance, $2,500 to remodel the kitchen and $500 for maintenance of a bathroom not located within the home office area. However, no portion of these expenses is deductible since they are unrelated to the business use of the home.

Expenses outside of the dwelling incurred for lawn care, pool maintenance or tree trimming cannot be deducted as business expenses. Further, expenses incurred on the inside of the house that are unrelated to the home office area are also not deductible, such as the remodeling or maintenance of any area other than the home office area. [Prop. Rev. Regs. §1.280A-2(i)(7)]

Conversely, if the broker paints and carpets the home office area, the entire cost of painting and carpeting the home office area is deductible as an expense directly related to the home office.

However, before the broker can deduct any of the home office costs as business expenses, the home office area must be used **exclusively** and **regularly** for his business.

**Exclusive use**

Consider a licensee who uses a family room as his home office. His family also uses the family room to watch TV in the evenings and occasionally entertain guests on weekends.

Thus, the area in the licensee's residence set aside for the home office is not used **exclusively** for the brokerage business. Since personal use of the area occurs during after-office hours, no home office deduction is allowed. [IRC §280A(c)(1)]

One or two rooms, and possibly an extra bathroom, often serve as space for the home office. The area dedicated to home office work does not need to be cordoned off or partitioned to qualify for exclusive use.

In addition to the home office area being dedicated exclusively to business activities, the home office must also be used **regularly** by the licensee for conducting his business.

**Regular use**

Consider a broker who maintains both a home office and an office in a nonresidential building. He works, keeps his files, conducts most of his real estate sales business and is assisted by a part-time secretary or team member at the nonresidential office.

However, the broker uses the home office four or five days each month in the evening to catch up on work he was unable to complete at the nonresidential office, such as reading real estate journals and studying to earn his continuing education credits for his license renewal.

Here, no deduction can be taken for home office expenses. The area used as the home office is not used regularly in the course of the broker's business. The fact that it is used exclusively for his business is not solely decisive since the exclusive use must be coupled with regular use.

If the broker meets the exclusive and regular use test, the home office must further qualify to take the allowable deduction under one of three standards of business conduct.

**Qualifying uses**

The final qualification for the deduction of home office expenses as a business expense requires a licensee to establish **he conducts business at the home office**, by meeting one of the following tests:

- the home office is used as a place of business to **meet or confer** with clients;
- the home office is located in a **separate structure** not attached to the residence; or
- the home office is the *principal place of business* for the licensee. [IRC §280A(c)(1)(A-C)]

The broker or independent contractor sales agent who uses the home office to **regularly** meet and confer with clients, is allowed to deduct home office expenses from brokerage income. The licensee should document the client conferences by keeping a calendar or log book showing the names of his clients, the date of each meeting with these clients at his home office and what they discussed or acted upon.

The home office of a broker or independent contractor sales agent located in a structure **separate** from the licensee's residence also qualifies for the deduction of business expenses. Examples include a detached garage apartment, outbuilding or casita.

If the licensee does not use the home office to meet or confer with clients, or the home office is not located in a separate structure, the licensee will need to demonstrate the home office is his **principal place of business** to qualify for the home office deduction.

**Principal place of business**

To qualify for the deduction of home office expenses based on its use as his **principal place of business**, the licensee must perform most of or the most important of his brokerage activities while working in the home office.

However, it is unusual for a real estate broker or independent contractor sales agent to spend all of his working hours of the business day or to perform all of his business activities at his office, no matter its location.

Typically, real estate brokers and agents, in the course of conducting a real estate brokerage business out of their home, use their office to:

- prepare agreements, disclosure documents and advertising copy;
- organize and schedule brokerage activities; and
- regroup after collecting information, investigating property and records, and meeting with others in the course of the business.

Thus, the question arises as to which place, among the locations used by the licensee to perform any business-related services, is the location of his **principal place of business**.

The location of the principal place of business is determined by a comparative analysis of the **importance and significance** of the real estate services performed by a licensee at various locations.

For doctors, the treatment of patients is the most important aspect of their practice. Thus, the location where the treatment is given is a doctor's principal place of business, which may be in a laboratory, hospital or care center. [**Soliman** v. **Commissioner of Internal Revenue** (1993) 506 US 168]

Accordingly, for criminal lawyers, if the representation of jailed clients is the entire practice, the location of the principal place of business may well be the court house or the county law library, where the services of defending the client and researching the legal aspects of the client's case occur.

Consider a self-employed broker who has no other office but his home office. He is claiming a home office deduction for the expenses incurred operating his office out of a portion of his residence based on its use as his principal place of business.

The broker's phone calls to clients and others to schedule his performance of any brokerage services are made from the home office. All listing agreements, purchase agreements, other contracts and disclosure documents are prepared or reviewed at the home office. All of the broker's records and files plus his word processor (computer), fax machine and office equipment are located in the home office.

Clients are not met at the broker's home office but at their offices or residences, at restaurants or at the location of the real estate involved. Personal face-to-face meetings with clients are for reviewing documents, the condition of the property involved (physical, title, operations, location and disclosure) and the status of the transaction, as well as obtaining signatures.

Business activities conducted outside the home office include previewing property, attending marketing sessions and multiple listing service (MLS) presentations and meeting with title officers, escrow officers, lenders, home inspectors, property management and maintenance services, government agencies and attorneys and accountants who represent clients. All of these activities are conducted at various places, but are arranged for and scheduled from the **home office**.

Does the broker qualify to deduct his home office expenses as expenses incurred at his principal place of business?

Yes! The home office costs are allowed to be expensed based on the use of the home office as the broker's principal place of business. The most important aspects of a brokerage practice are soliciting and coordinating client contacts, preparing agreements, analyzing disclosure statements and maintaining files and records, all of which are performed in the broker's home office.

Obtaining signatures on documents, inspecting property and meeting with others at locations outside the home office are essential, but not the most important aspects of the licensee's business.

**Two offices — one for the public**

A licensee with both a home office and a nonresidential office can still qualify for the deduction of home office expenses.

Consider a sales agent who maintains desk space in a downtown office with several other licensees, a space sometimes called a "cubby." The licensees using the downtown office share its maintenance and operating costs, such as employing a receptionist, contributing to rent and paying for janitorial services and utilities for the premises.

The sales agent pays a pro rata share of the costs based on his actual share of the space he uses. The office merely provides the sales agent with a "public" business address, a more professional place for meeting clients than coffee shops or the client's office or residence.

The sales agent also has a home office. All of his phone solicitations and contacts with clients and others while performing his brokerage services are made by phone, fax or email from the home office or while on the road. All agreements and disclosure forms are prepared at the home office and all of his records, files and office equipment are located at the home office.

Appointments to meet with clients or real estate affiliates or to show property are also made from the sales agent's home office. He only uses the downtown office as a "window" to meet clients before showing property, confer with them in person and obtain their signatures on documents.

Here, the sales agent qualifies to deduct expenses incurred at his home office from his business income. The importance of the activities conducted at the home office and the time spent on carrying out those activities establishes the home office as his principal place of business.

Even though he has a nonresidential office for professional reasons, the most important part of his work (soliciting, conferring, preparing documents and packaging transactions) takes place at the home office. [**Beale** v. **Commissioner** TC Memo 2000-158]

**Two offices — main office is downtown**

Now consider a broker who makes more substantial use of his nonresidential office than of his home office.

The broker maintains an office downtown that he uses daily to solicit, make appointments with and meet clients. He also arranges property inspections, escrows and title information, and prepares agreements and disclosures from the downtown office.

The broker's home office is used for his bookkeeping, maintaining his real estate library and studying. He occasionally phones clients, receives calls and reviews documents at his home office. He spends one or two hours most evenings working in the home office.

Here, the broker's use of the home office is insufficient to qualify the home office as his principal place of business.

The most important activities — client contacts in person and by phone, packaging deals and preparing agreements — take place primarily at the downtown office.

While the bookkeeping and studying at the home office is essential to the broker's ability to continue conducting his brokerage business, they are not the most important part of his business. It is rendering services in the practice of real estate brokerage on behalf of clients that is most important, and these services for the most part do not occur at the broker's home office. [Beale, *supra*]

**Sales agents and the home office**

Although brokers generally work for themselves, sales agents always work as *employees of a broker* and typically maintain a desk in their broker's office. However, the broker's employment and supervision of a sales agent, mandated by state law, does not limit the ability of the sales agent to qualify for the home office deduction.

Taxwise, a sales agent must first qualify as an independent contractor with his broker before he can deduct home office expenses.

A sales agent's independent contractor tax status is established by a written employment agreement between the sales agent and the broker, stating the sales agent is considered an independent contractor and will pay his own income taxes without the broker withholding. Nothing more is required to establish his independent contractor status for tax purposes. [See **first tuesday** Form 506]

For example, a real estate sales agent is assigned a desk in his broker's office. The sales agent uses the office to meet clients and prospective buyers before taking them to look at real estate. Occasionally, he meets clients at the real estate involved instead of at the office. The office is used to review active files with his employing broker once each month.

The sales agent also has a home office where he maintains a business phone line to solicit and confer with clients and to contact real estate affiliates regarding his due diligence investigation into properties and transactions under his care. He also prepares agreements and maintains all his records and office equipment at his home office.

Here, the sales agent qualifies to deduct the expenses incurred in maintaining the home office as his principal place of business, even though he works for a broker and has desk space in the broker's office.

The sales agent uses his desk at the broker's office only as a window to meet his clients. His meetings with the broker are administrative, not part of the services rendered to clients, but required for the broker to supervise the sales agent's conduct and file maintenance.

However, the most important tasks of the sales agent's real estate practice take place at the home office. Those tasks include preparing and reviewing documents and scheduling meetings and phone conferences with clients, customers and third-party service providers.

**Limitations on deductions**

Consider a real estate sales agent who uses his residence as his principal place of business. Each year, he writes off his home office expenses as a deduction from his sales income.

The agent's real estate business suffered a net loss during the past year. That loss included home office expenses.

However, real estate business losses, which include home office expenses, are limited by the Internal Revenue Service (IRS). Losses cannot be taken to the extent they contain home office expenses. Thus, no portion of the loss can be home office expenses. [**King** v. **Commissioner** TC Memo 1996-231]

# Chapter 31 Intra-family transfers avoid reassessment

*This chapter presents the exclusion from reassessment on a child's acquisition, by sale or gift, of California property conveyed to them by their parents or grandparents.*

***Chapter 31 Outline***

*Exclusion for gifts and sales*
*Assessed value*
*Change of ownership*
*Excluded transactions*
*Intra-family transfers*
*Generation skipping on death of a child*
*Who qualifies?*
*Principal residence*
*$1,000,000 assessment exclusion*
*Allocation of exclusion to land or improvement*
*Filing a claim*
*Final considerations*

***Chapter 31 Terms***

| | |
|---|---|
| *Apportionment* | *Full cash value* |
| *Change of ownership* | *Homeowner's exemption* |
| *Current assessed value* | *Inter-spousal transfer* |
| *Change in control* | *Parent/child exclusion* |
| *Disabled veteran's exemption* | *Principal residence* |
| *Exemption from assessment* | *Selective allocation* |

**Exclusion for gifts and sales**

An older couple owns residential income properties that are unencumbered by mortgage debt. They would like to rid themselves of the management and are considering selling the rentals.

The sales proceeds would be reinvested in interest-bearing notes and bonds. The situation is discussed with their children, who live nearby and have had experience in all aspects of managing the properties.

The children express an interest in aquiring the properties as investment income for themselves, taking on the management their parents no longer want. The couple, having already reviewed their situation with a real estate agent, now discusses the possibility of selling the properties to

their children with the assistance of the agent. The couple desires a fully documented and arm's length arrangement with their children, but at a price below the current fair market value of the property and without a down payment in cash.

The couple does not want their children to use their own cash to buy the properties and will carry an installment note at the minimum applicable federal rate (AFR). The broker expands the discussions to include the possible sale of the couple's principal residence to one of the children who lives locally and could use a larger home for his family.

The couple is intrigued by the broker's comments on the ability of their children to become the owners of the properties without reassessment on the property tax rolls to current fair market value.

One of the properties has a market value of $1,100,000. Conveying the property to an investor would be a *change of ownership* triggering reassessment of the property to its current *full cash value* — $1,100,000. The property's present assessed value is $500,000, which comprises a $325,000 basis and a maximum annual inflation adjustment during their ownership of 2% per annum, compounded. While the taxes now paid by the parents are $5,000 annually, a buyer on acquiring the property would pay $11,000 annually in taxes since the property would be reassessed at current market prices (**full cash value**).

The children, on the other hand, qualify to acquire the property without reassessment. Each parent has a separate exclusion from reassessment when transferring properties to their children. Each exclusion covers the properties' *current assessed values* up to $1,000,000. Thus, the couple holds a combined exclusion of $2,000,000 in assessed value, which can be applied to a **sale or gift** of properties to their children, without regard to the current fair market values of the properties.

Thus, the children, on buying the residential income properties, continue to pay the same property taxes their parents paid; there is no reassessment and no increase in taxes. The children save $6,000 in property taxes during the first year alone by buying their parents' properties rather than acquiring a comparable property of the same value from another seller. Each year thereafter, the amount of tax savings will increase since the 2% annual inflation adjustment is based on the assessed value ($500,000), not on the current fair market value of $1,100,000.

Further, the current property taxes are 5% of the gross rental income. The purchase of the couple's property by a non-family member would cause the taxes to rise, expending over 10% of the gross rental income on the payment of property taxes. Thus, the purchase of the properties will increase the children's net operating income by $6,000 the first year, providing an extra cushion against any downturn in the local economy that might increase the rate of vacancies and turnover of tenants.

As for the couple's principal residence, a separate exclusion without any assessed value limitation (and no fair market value limitation) allows a child to acquire his parents' residence without triggering reassessment. The child is permitted to take over the parents' assessment since the

property is the principal residence of the parents. Thus, the annual cost of owning the residence will not increase on conveyance to the child, as it would if any other person bought the residence.

The couple quickly concludes it is financially advantageous to keep the properties within the family, especially since they have good reason to believe their children have the temperament and ability to operate the rentals successfully.

The broker's duties will include:

- assisting and advising in preparation of a purchase agreement;
- setting an agreeable price;
- setting the terms of payment by obtaining a purchase-assist mortgage or using a carryback note with an acceptable rate of interest;
- dictating escrow instructions; and
- assisting with the change of ownership report the children must file with the assessor on taking title.

It is the report to the assessor that will set forth their claim of exclusion for reassessment, since each parent has a $1,000,000 assessed value exclusion available for the children to claim.

**Assessed value**

Local property taxes are imposed and collected according to a real estate's **full cash value** on the date of acquisition (the change of ownership), which is adjusted annually for inflation up to 2%. The higher the assessed value, the greater the tax.

Local taxes are limited to one percent of the property's *assessed value* for the fiscal year (July 1 to June 30). [Calif. Constitution, Article 13A §1(a)]

Property taxes for the upcoming fiscal year are set based on a property's **assessed value**, which is its full cash value set on either:

- March 1, 1975, plus an annual 2% maximum adjustment for inflation [Calif. Revenue and Taxation Code §110.1; Calif. Const., Art. 13A §2(b)]; or
- the date the property is sold, is improved or undergoes any other change of ownership after March 1, 1975, plus the annual 2% maximum inflationary adjustments thereafter. [Calif. Const., Art. 13A §2(b)]

Accordingly, property today is only reassessed when its ownership is changed or it is improved by construction or sustains a casualty loss that goes unreplaced. Also, temporary annual reductions occur if the property's fair market value drops below its current assessed value.

Since 1975, when the assessed full cash value of all taxable (non-exempt) properties was set, real estate market values have increased significantly beyond the price adjusted for the annual 2% inflation.

An owner of real estate can benefit by retaining his ownership of a property since the property's operating costs (and thus, property taxes) are less over time than they would be under new ownership.

The 2% inflation ceiling on property taxes during ownership is a feature that induces owners to retain their properties, rather than sell and acquire new ones.

Consequently, two neighbors owning adjacent properties with identical market values often pay vastly different sums on their property taxes, depending on when they acquired their properties.

Before discussing the parent-child exclusions from reassessment on a change of ownership, it is necessary to first review what activities constitute a **change of ownership** and trigger reassessment on their occurrence.

### Change of ownership

To trigger reassessment, a substantial **change of ownership** must occur.

A change of ownership occurs when the owner transfers a present interest in the real estate, which:

- includes the beneficial use of the real estate; and
- has a value substantially equal to a fee interest. [Rev & T C §60]

Every person acquiring an ownership interest in real estate must file a change of ownership report with the county assessor. On the change of ownership report, the buyer must indicate whether an exemption or exclusion applies.

Unless the transfer is exempt or excluded from reassessment, the real estate interest conveyed must be reassessed at its current full cash value, typically represented by the price paid by the new owner.

An *exemption from assessment* indicates the property is not considered taxable, such as real estate owned by:

- local, state or federal government;
- churches and religious organizations;
- universities and colleges; and
- charities and nonprofit hospitals. [Rev & T C §§201, 214]

An **exclusion indicates** the property under the new ownership is taxable, but the transfer to the new owner does not trigger reassessment. Thus, the prior owner's full cash value assessment, plus the annual adjustments for inflation, remains the assessed value for the new owner. [Rev & T C §§69.5, 201.4, 202, 203, 205.5]

Frequently, the terms "exemption" and "exclusion" are carelessly interchanged. However, for transfers of privately-owned real estate to avoid reassessment, the new owner must depend on an exclusion by filing a claim with the county assessor at the time of the conveyance or within the period of limitations.

**Excluded transactions**

While most transfers of title trigger reassessment, some do not. For example, a mere change in the vesting used by an owner or owners to hold title to a property is not a change in ownership. However, the proportional interests held by the co-owners before they changed their vesting must remain the same after the transfer.

Changes in vestings between joint tenants, tenants-in-common, community property or a co-owner's partnership or corporation are excluded from reassessment as long as the share of ownership held by each co-owner remains the same in the new vesting.

Also, transfer of a partner's interest in a partnership, such as an assignment of a partner's interest, that does not alter the control of the partnership, will not trigger reassessment of the real estate owned by the partnership. [Rev & T C §64(a)]

*A change in control* by partners of a partnership that triggers reassessment occurs when more than 50% of the ownership interests held by the partners in the partnership are sold. Such a high percentage is one of the benefits of having several persons hold title in a limited partnership or LLC rather than as tenants in common. [Rev & T C §§64(c), 25105]

Conversely, on the transfer of a fractional interest in the vested ownership of the real estate, such as the transfer of a tenant-in-common interest, that fractional ownership interest transferred is reassessed. [Rev & T C §65.1(a)]

However, when a vested owner sells less than a 5% ownership interest valued under $10,000, it is not reassessed. [Rev & T C §65.1(a)]

It is not possible, however, to exploit two exclusions in the same related series of transfers. The end result would be a reassessment without any exclusion. The multiple steps are collapsed and viewed as one step by the county assessor, and the property interest conveyed is then reassessed. [**Crow Winthrop Operating Partnership** v. **County of Orange** (1992) 10 CA4th 1848]

**Intra-family transfers**

Transfers between spouses, called *inter-spousal transfers*, are also excluded from reassessment. Thus, no assessment will take place after the transfer between spouses. [Rev & T C §63]

Transfers between husband and wife are not considered changes in ownership that trigger reassessment if the transfer:

- adds a spouse to title;
- reports the death of a spouse; or
- settles a divorce. [Rev & T C §63]

Also, the transfer of a principal residence and up to $1,000,000 in assessed value of other real estate from a parent to his child, or from a child to his parent, is not considered a change in ownership that triggers reassessment. [Rev & T C §§63.1(a)(1), 63.1(a)(2)]

The *parent/child exclusion* works in two ways — applying to transfers from **parent to child** or from **child to parent**. [Rev & T C §63.1(c)(1)]

**Generation skipping on death of a child**

Occasionally, grandparents lose a son or daughter by death, leaving only their grandchildren as direct descendants. For grandparents who wish to transfer their principal residence or other properties to their grandchildren, whether by sale or by gift, the principal residence exclusion and the $1,000,000 assessed value of other property can be used to avoid reassessment on the transfers. Thus, it is possible to skip a generation and pass on the same assessed value of the property at the time of transfer.

However, a grandchild who has already been deeded the principal residence of his parent's (now deceased) and has avoided reassessment on the conveyance by claiming the parent's principal residence exclusion, cannot also receive a principal residence of the grandparent and claim another principal residence exclusion from reassessment. This bar against a grandchild receiving more than one property under a principal residence exclusion applies only to a transfer between grandparent and grandchild.

On the other hand, the $1,000,000 reassessment exclusion held by grandparents can be used to exclude the transfer of the grandparents' principal residence to a grandchild by treating it as other property.

The $1,000,000 exclusion from reassessment each grandparent holds for conveyances to grandchildren is first reduced by any prior allocation of the $1,000,000 to transfers of property to their children. The exclusion amount is then reduced by any prior allocation on conveyances to grandchildren (after the death of the parent/grandparents' child). The remaining amount of the exclusion is then further reduced by any amount of the deceased parent's (grandparents' child's) $1,000,000 exclusion claimed by the grandchild to avoid reassessment of properties sold or given to the grandchild by the deceased parent. Thus, the grandchild does not receive more from the grandparents than the remainder of the $1,000,000 exclusion unused and held by their deceased parent.

Also, a grandparent cannot sell or give his principal residence to his grandchild while, on the same transfer, making a claim to carry the assessed value of his principal residence forward to a

replacement principal residence he acquires that is of equal or lesser value, in an attempt to simultaneously use the 55-or-older principal residence exclusion with the grandparent/grandchild exclusion. [Rev & T C §63.1(d)(1)(B)]

**Who qualifies?**

The **parent-child exclusion** only applies to transfers between parents and children. [Rev & T C §63.1(a)(1)]

The definition of a "child" includes a parent's:

- natural child [Rev & T C §63.1(c)(3)(A)];
- stepchild or the stepchild's spouse [Rev & T C §63.1(c)(3)(B)];
- son-in-law or daughter-in-law [Rev & T C §63.1(c)(3)(C)]; and
- adopted child. [Rev & T C §63.1(c)(3)(D)]

**A child does not include:**

- a natural child who has become the adopted child of another parent [Rev & T C §63.1(c)(3)(A)]; or
- a child who was adopted after turning eighteen years of age. [Rev & T C §63.1(c)(3)(D)]

Each parent and child has **two reassessment exclusions**:

- the transfer of a *principal residence*; and
- the transfer of up to $1,000,000 assessed value of other property. [Rev & T C §§63.1(a)(1), 63.1(a)(2)]

**Principal residence**

To exclude the transfer of a principal residence from reassessment, the parent or child conveying their principal residence must now hold either:

- a *homeowner's exemption*; or
- a *disabled veteran's residence exemption*. [Rev & T C §63.1(b)(1)]

Both are granted by the county assessor.

The child or parent acquiring the property does not need to occupy the property as their principal residence to file a claim with the assessor for the reassessment exclusion. After the transfer, the child or parent receiving the property can use it for any purpose, such as a rental.

No assessed value limit exists on the principal residence exclusion. The residence can be worth any dollar amount, be assessed at any dollar amount and still be transferred from parent to child, or child to parent, without reassessment.

A **principal residence** is limited to the portion of land surrounding improvements that are used for dwelling purposes. This separates the portion of land used for other purposes from the portion of the land containing the residence, called *apportionment*. [Rev & T C §63.1(b)(1)]

Thus, a residence on a large parcel is subject to apportionment on a transfer. Ranches, groves or sub-divisible acreages transferred with a residence are examples of property that also requires **apportionment**.

A parent or child may transfer any number of their principal residences over the years under the principal residence exclusion. However, the dwelling must qualify as their "principal residence" at the time of transfer by having a homeowner's or disabled veteran's exemption.

Here too, parents who transfer their principal residence to a child using the principal residence exclusion or the $1,000,000 other property exclusion to avoid reassessment on the conveyance to the child, **cannot also use** the 55-or-older assessment exclusion to carry their old assessment forward. Only one type of tax relief is permitted on the transfer of the parent's principal residence.

**$1,000,000 assessment exclusion**

Parents and children can transfer **all other real estate** to each other without concern for the transfer of their principal residence, and up to $1,000,000 of current assessed value without triggering a reassessment. [Rev & T C §63.1(a)(2)]

**Each child and each parent** has a separate $1,000,000 assessed value exclusions. When the real estate transferred by the parent or child has an assessed value under $1,000,000, it is transferred without reassessment. [Rev & T C §63.1(b)(2)]

Likewise, if there are a number of properties, all will be excluded from reassessment if their total assessed value is under $1,000,000. [Rev & T C §63.1(b)(2)]

Parents can combine their separate $1,000,000 exclusions to jointly convey property for a total combined exclusion of $2,000,000. Also, children can combine their individual exclusions when conveying jointly-owned properties to their parents. [Rev & T C §63.1(b)(2)]

However, parents cannot combine their exclusion with a child's in order to deed to another child without reassessment. To qualify for the $1,000,000 other property exclusion, the transfer must be from parent to child, or child to parent — not child to child, for which there is no exclusion available. Parent to parent transfers must qualify under the **inter-spousal exclusion** to avoid reassessment.

Now consider a parent who uses his entire $1,000,000 exclusion to transfer property to one of his children. He cannot later transfer property other than his principal residence to another child without reassessment. For each child to equally benefit from the intra-family $1,000,000 reassessment exclusion, the parent may allocate a pro rata amount to each child as transfers occur, retaining the unused portion of the $1,000,000 exclusion for future transfers to other children.

**Allocation of exclusion to land or improvement**

The assessed value of the real estate owned by a parent and transferred to a child might exceed the amount of the $1,000,000 exclusion the parent has remaining or has allocated to a child for a transfer.

When a child receives real estate that has a value exceeding the amount of exclusion available to him, he must allocate his exclusion to:

- the land only;
- the improvements only; or
- both land and improvements.

When using the amount of the $1,000,000 exclusion available, an allocation should first be made to the portion of the real estate that has appreciated the most in market value, be it the land or the improvements. This is to avoid reassessment of the portion of the real estate that has inflated most in value above the assessed value.

If the percentage increase in the value of the land is greater than the percentage increase in the value of improvements, the allocation should first apply to the land since any reassessment of the land will result in higher taxes than a reassessment of improvements would.

If any amount of the exclusion remains, it should then be applied to the improvements.

Conversely, when the percentage increase in the value of the improvements exceeds the percentage increase in the value of the land, the exclusion should first be allocated to the improvements.

A reassessment is minimized by applying the exclusion first to the portion of the real estate that has increased at a higher rate.

For example, a parent transfers a ranch to his child. The property has an assessed value of $1,500,000 — $1,000,000 to land (two-thirds) and $500,000 to improvements (one-third).

The ranch's current market value is $8,000,000 — $6,000,000 to land and $2,000,000 to improvements.

The value of the land has appreciated $5,000,000 (500%) while the improvements have appreciated $1,500,000 (300%).

The county assessor allocates the exclusion based on the assessed value ratio of land to improvements — $667,000 to the land and $333,000 to the improvements, totalling a $1,000,000 amount that will be excluded from reassessment. The balance of the property's assessed value is $500,000 ($1,500,000 minus $1,000,000) and equals one-third of the property, which will be reassessed to reflect the current fair market value since it is not sheltered by the parent-child exclusion.

Thus, one third of the property's current market value of $8,000,000 is added to the $1,000,000 assessed value retained under the exclusion. Accordingly, the ranch's reassessed value will be $3,670,000 — $1,000,000 plus $2,670,000 (one third of $8,000,000). However, the child in this example can further minimize his property tax liability by *selectively allocating* the exclusion only to the land.

The child should allocate all of the $1,000,000 exclusion to the land since the value of the land has increased at a higher rate than the value of the improvements. The land then will not be reassessed since, at an assessed value of $1,000,000, it is fully sheltered by the amount of exclusion. However, the value of the improvements will be reassessed at current market value, to its **full cash value**.

Here, the ranch's new assessed value on reassessment of just the improvements will only be $3,000,000, represented by $1,000,000 (the excluded amount of the land's value) plus $2,000,000 (the reassessed value of the improvements). The child minimizes the amount of future property taxes by selectively allocating the total exclusion to the land. The child saves an additional $670,000 through **selective allocation**, instead of using the assessor's allocation ratio.

## Filing a claim

To qualify for the principal residence exclusion or the $1,000,000 exclusion, each parent or child receiving property must file a claim for the exclusion with the county assessor. The claim should be filed with the assessor when the deed is recorded. It is noted on the change of ownership report form supplied by the assessor. The assessor, in turn, tracks the parents' and children's exclusion amounts through the California Franchise Tax Board (FTB). The FTB acts as a clearing house to monitor the total exclusion amounts claimed by each property owner.

If, on the transfer of property, most of the $1,000,000 exclusion has been used already, the real estate will be reassessed and only the unused portion of the exclusion remaining will be granted. The balance of the real estate's assessed value that is not excluded from reassessment will be reassessed for its pro rata share of the property's full market value.

## Final considerations

The parent-child $1,000,000 reassessment exclusion on a transfer does not cover real estate owned by the parent or the child that is vested in an LLC, partnership or corporation. [Rev & T C §63.1(c)(6)]

In a parent to child transfer, where title is held in a family partnership or corporation, the property should first be deeded back to the parent before he deeds it to the child under the exclusion.

The two steps must be completed in separate, unrelated transfers, preferably in different fiscal years, to avoid the collapse of a two-step transaction into one step, which would lead to reassessment. [Rev & T C §63.1; **Shuwa Investments Corporation** v. **County of Los Angeles** (1991) 1 CA4th 1635]

The child can, in turn, then transfer the property into his own partnership or corporation without reassessment. Again, the second transfer must be totally unrelated to the first transfer.

Parent-child transfers to and from an *inter vivos trust* are excluded from reassessment. [Rev & T C §63.1(c)(9)]

Also, no restrictions prevent a parent conveying property from continuing to occupy the transferred property. Also, the transfers do not necessarily need to take place as part of estate planning — although most probably do.

The transfer to a child can occur at any time. The parent-child exclusion is an encouragement for families to retain ownership of their real estate rather than sell and obtain replacement property.

For brokers, this means fewer sales of investment-quality real estate due to the owner's ability to keep the real estate in the family and enjoy lower property taxes.

# Economics

# Chapter 32 Employment prerequisite to renting or owning

*This chapter introduces the crucial need individuals have for employment to provide the income flow needed to rent or own housing.*

***Chapter 32 Outline***

*Income for the necessities of life*
*Quantity of employed individuals*
*Reeling from California's lack of jobs*

***Chapter 32 Terms***

*Employment* *Under-employment*
*Rentals*

**Income for the necessities of life**

The **quantity of jobs** in California directly impacts homeownership statewide. Without a paycheck, nobody can afford to rent an apartment, or buy a house, unless they are subsidized by the government or possess substantial independent wealth.

The basis for an individual's **creditworthiness**, essential if they are to rent or borrow money for housing, is a paycheck, self-employed earnings from a trade or business, or income from investments.

When a jobholder decides to buy a home today, his decision to buy a particular property is influenced by the amount of his savings for a down payment, a lender's willingness to lend to the homebuyer and any available government promises of subsidies for the purchase.

Thus, of all the factors affecting the real estate economy, **employment** throughout California's population has the most impact on the vigor of the real estate market, whether in good economic times, times of financial crisis or economic recession.

Without jobs, wage earners have **no financial ability** to make rent or mortgage payments.

Thus, the unemployed are financially unable to occupy any type of residential property. Also, without work to provide jobs, businessmen have no need to occupy and use retail space, office suites, warehouses for inventory and distribution, industrial buildings for production or land for development.

Demand for all types of real estate rises as the number of local jobs increases (as during periods of economic development or boom). Additions to the local labor force tend to drive rents and prices up on properties in the vicinity.

On the other hand, a decline in the number of local jobs reduces the need for all types of real estate (as during a recession). Reductions in local employment lead to lower rents and prices paid by tenants and buyers for the occupancy and use of real estate.

The current trend of individuals employed in a region sets the direction for:

- the **volume of rentals** and sales in the local real estate market during the following 12 to 18 months; and
- the **movement of rents** and prices paid for the use and occupancy of all types of real estate in 24 to 30 months.

**Figure 1**

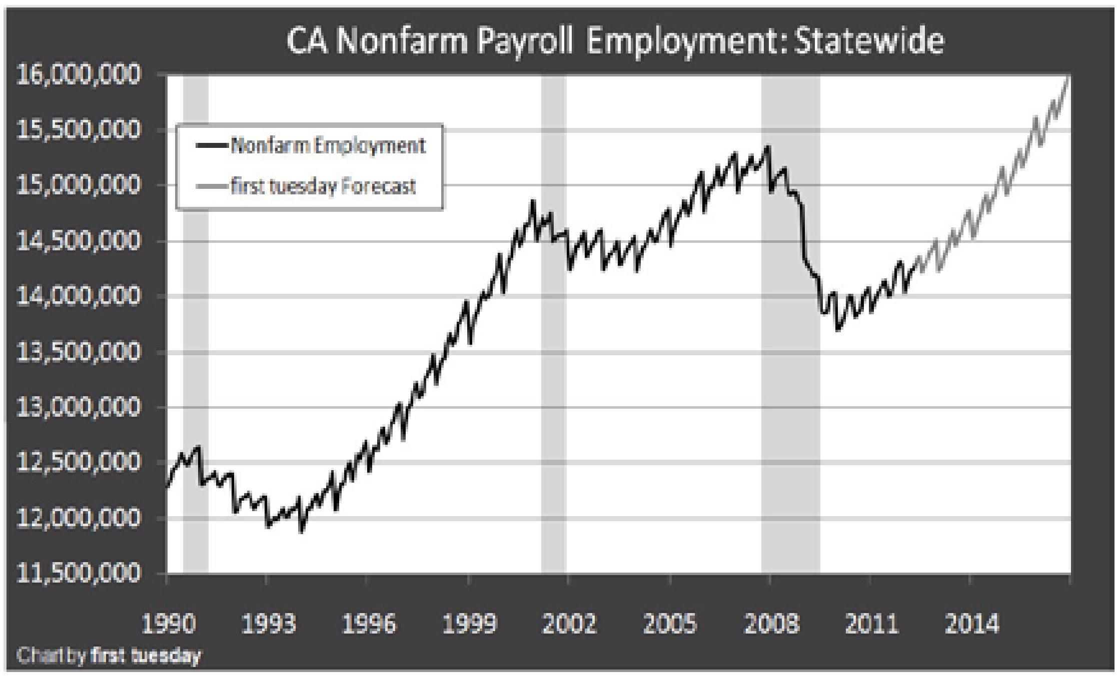


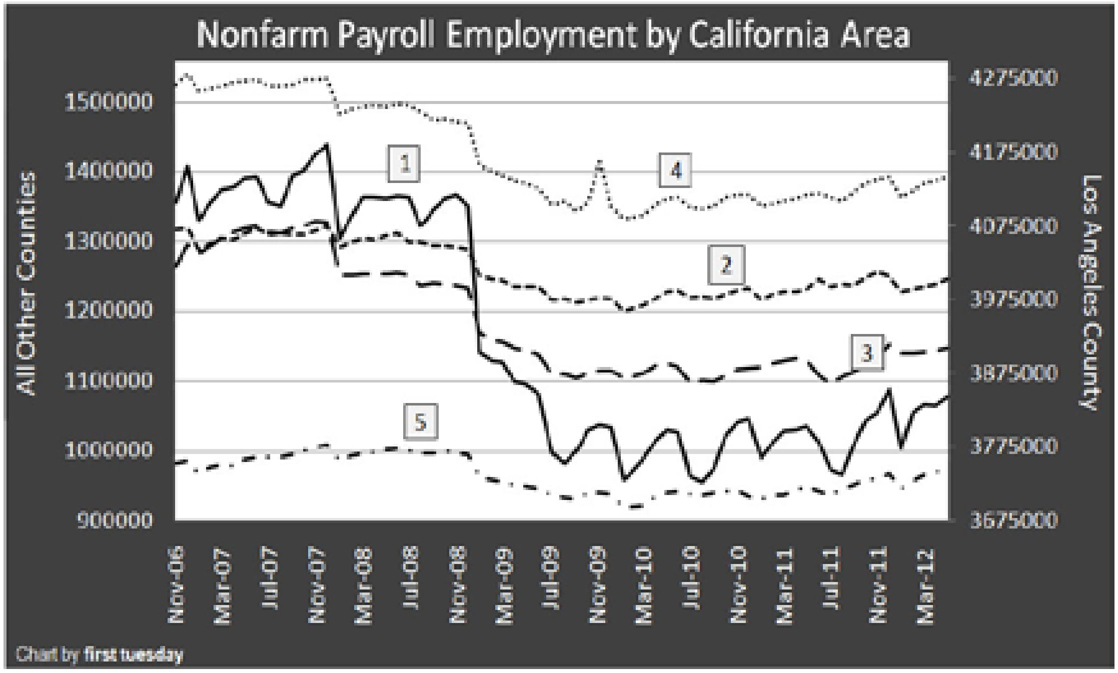

*Figure 1 and Figure 2 track the single most important factor in determining the past and future of real estate in California: the number of people employed. These charts review total employment numbers statewide (Figure 1) and individually (Figure 2) for California's five most populous counties at the time of publication. The gray bars indicate periods of recession in the United States Economy (as tracked by the National Bureau of Economic Research).*

*Data Courtesy of the California Employment Development Department (Labor Market Information Division).*

**Frequent updates of this and other charts are available at:*
***http://firsttuesdayjournal.com/jobs-move-real-estate/***

Smartphone users may scan this QR-Code for chart updates.

**Figure 2**




*1. (Left Axis)* *Orange*
*2. (Left Axis)* *San Diego*
*3. (Left Axis)* *Riverside*
*4. (Right Axis)* *Los Angeles*
*5. (Left Axis)* *San Francisco*

*Data Courtesy of the California Employment Development Department (Labor Market Information Division)*

**Frequent updates of this and other charts are available at:*
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Smartphone users may scan this QR-Code for chart updates.

Other jobs issues which affect the level of rents and prices paid for property include:

- **quantity** of employed individuals;
- **quality** of jobs available; and
- **type** of jobs existing and developing in the local market.

**Quantity of employed individuals**

Historically, jobs in California create homeowners and tenants on an approximate 50:50 basis, with half of all households owning the residence they occupy and the other half renting it.

The appreciation or depreciation of property values is triggered by increases or decreases in local population density and the economics of the jobs (read: numbers and pay levels) held by the local population.

The **unemployed**, the **under-employed**, and the rate of unemployment are of no concern to the present real estate market, since these populations do not rent or buy real estate — they first need a full time job to do so.

Figure 1 and Figure 2 track the single most important factor in determining the past and future of real estate in California: the number of people employed.

These charts review total employment numbers statewide and individually for California's five most populous counties at the time of publication.

The gray bars in Figure 1 indicate periods of recession in the United States Economy (as tracked by the National Bureau of Economic Research). [See Figures 1 and 2]

**Reeling from California's lack of jobs**

The overall rate of California unemployment dropped to 10.4% in May 2012. Meanwhile, the labor force participation rate rose slightly, to 63%.

These are positive signs, but the continuing low rate of labor force participation indicates that much of the population remains highly pessimistic about their ability to find work in the present market and is no longer actively looking for a job. Until jobs increase significantly, home sales volume has no chance of recovery.

# Chapter 33 It's the demand, stupid!

*This chapter casts a critical eye towards the supply-side paradigm, and posits that in recessionary periods, and particularly during periods of zero-bound interest rates, the real estate recovery is propelled by demand from organic buyer-occupants – the end users of property.*

***Chapter 33 Outline***

*"If you build or list it they will come"*
*The demand side paradigm shift*
*Organic indicator of demand*
*Let's do the math*
*Speculator activity is not any part of demand*
*Life-cycle of a speculator*

***Chapter 33 Terms***

| | |
|---|---|
| *Buyer-occupant* | *Long-term investor* |
| *Buyer's market* | *Seller's market* |
| *Demand* | *Speculator* |
| *End user* | *Supply* |
| *Flipper* | |

**"If you build or list it they will come"**

To those vociferous quibblers who proclaim the elixir to the real estate market's ills is **supply**, listen up! While sales volume is temporarily propped up by speculators snatching up inventory, this is but a **mini-boom** in reported sales, and does not paint a picture of market realities one year hence (2013 and beyond as we ride out this *bumpy plateau recovery*).

Changes in the availability of real estate inventory, known as *supply,* inversely affects the price of property. Worse, in a recovery era of **zero-bound interest rates** as we have today, the market is not driven by supply – it's driven by **demand**.

This truism will soon be felt around 2013, when the current speculator-fueled mini-boomlet subsides and the hot money finds somewhere else to park itself.

During the past 30 years, real estate sales of all types of property operated under *supply side paradigm* behavior. The **supply side paradigm** was a boon to the construction industry, seller's agents and sellers as their jobs were made easier by the ever-enlarging availability of **mortgage funds** at constantly lowered rates for any entrant they were able to drag to the table for the closing of a real estate deal.

These roughly 30-year periods of dropping interest rates are known as *seller's markets*. In a **seller's market**, sellers command a high price, knowing that energized buyers with ready access to cheap money will always be available to continuously sop up the housing supply. If a property is built and offered for sale, it will invariably be sold since, under the supply side paradigm, there is always a demand for housing.

In stable or rising markets, the supply of available units for purchase is indicative of the health and momentum of the market. Under this market reasoning, so long as there is supply, as a matter of certainty, demand will equal (or likely exceed) it.

And the mantra continued: list, list, list and build, build, build.

**The demand side paradigm shift**

However, we are still stumbling over the washboard shaped recovery of what has become the *Lesser Depression*, forged by a massive and widespread **financial crisis**.

Though the speculator-propelled boomlet we're currently experiencing has provided a false sense of hope for some, it is fleeting. This is decidedly NOT a seller's market — or at least won't be once the mini-boomlet crests. The supply-side way of thinking is ill fit to the forthcoming realities, a truth that will likely be in effect well into the next two or three decades of interest rate movement.

In recovery periods shackled – **trapped** – with zero interest rates, embracing the supply side paradigm is akin to donning a thick, thermal pelt after the ice age has passed. It is discordant to the point of being laughable, and resistant to evolutionary necessities imposed by the liquidity trap placed on sellers by zero-bound interest rates. You simply cannot escape ownership by raising or keeping prices high and waiting.

Proponents of the confused supply side paradigm claim to witness both multiple listing service (MLS) inventory slipping and prices dropping – two trends which cannot exist concurrently, in violation of the basic laws of supply and demand. If prices were going up, supply would then become relevant again.

Real estate price indexes going forward are, quite simply, a story of **demand**. Adjust your survival plan accordingly by giving ardent attention to the type of buyers you represent, or prepare for a bitter future ahead.

California brokers take note, at your next monthly award ceremony to traditionally give public recognition to the agent who brought in the most property listings to the office, change the language of your award certificate to read instead, "Agent who contributes most to our forthcoming Chapter 11 petition."

**Organic indicator of demand**

Before the level of buyer demand can be properly gauged, the factors which **create demand** must first be determined.

The only real indicator of long-lived organic demand is the *end user* of a property. Every **builder** of subdivision homes knows speculators are the death of his expansion into the next stage of development since they are not users, but **usurpers**.

The **end user** of a property is a buyer who will take personal possession of the property for a **considerable length of time**, as would a collector. Thus, the end user most frequently takes the form of a *buyer-occupant*, one who purchases property for use as shelter for his family or business, and takes steps to retain the property as a store of his wealth for as long as it serves the purposes of his occupancy.

In addition to buyer-occupants, *long-term investors* are also a key player in demand. **Long-term investors** purchase a property with the intent of renting it out to tenants to produce a steady income flow, a process also known as **buy-to-hold**. Thus, they are collectors at heart.

As with buyer-occupants, **duration of possession** is the key factor determining whether they are an end user of a property. It is purchases by these end users which reflect the true level of **organic demand** in a market – everything else is noise, temporary distractions and fluctuations which attempt to extract profits from the market, transitory actions devoid of any actual demand for the item being offered, i.e., long-term possession of the property.

**Let's do the math**

But what about the obverse side of this ownership coin?

*Absentee homebuyers*, a group consisting of *speculators* and *renovators* (and true *buy-to-hold investors*) accounted for 28% of Southern California non-foreclosure-related sales in April, 2012, near the record high of 30%. In Northern California, **absentee buyers** made up 24% of homebuyers, down from a record high of 26%. Note the trend.

Critically, these percentages do not include the estimated **one third** of all trustee's sales that were picked up by **speculators**.

Thus, when you combine absentee homebuyers (and subtract buy-to-hold investors who are long-term income property owners) then add speculators at trustee's sales, approximately **half of all transactions effecting a change of ownership** do not currently go to the end user.

**Speculators**, who by profession contend with a high degree of risk, come in two basic species:

- **quick flippers**, also known as *hot money handlers*, who add no value and invest little to no money in a property. Flippers purchase properties (mostly of the low-tier, distressed variety) with the intent of selling them at a higher price at a later date (and renting short-term if necessary to reduce their negative cash flow); and

- **renovators** who add value to a property before attempting to flip it.

Flippers rely solely on the upward dynamics of a *momentum market*, pocketing any price appreciation by sandwiching themselves between the seller and the ultimate end user of the property (read: the buyer-occupant or *buy-and-hold investor*).

Similarly, renovators add value to a property by rehabilitating it before selling it back into the market. Renovators frequently target damaged low- to mid-tier properties and improve them, bringing the property's amenities and appearance to a level consistent with that of the surrounding neighborhood.

*Editor's note – Preferably, the improvements are not to a degree which* ***over-improves*** *the property so it becomes the most valuable in the neighborhood, as a renovator will find it difficult to recapture his investment.*

Similar to flippers, renovators do not intend to hold and maintain the property for the long-term. Instead, they want to limit the length of time it is in their possession, typically 75 to 90 days to complete their renovation work, then immediately release it back into the market.

Unlike their **quick flipper** brethren, renovators contribute **value** to the property by returning it to a state fit for occupancy. Renovators also help the property avoid *obsolescence* by replacing fixtures which are out of date.

**Speculator activity is not any part of demand**

Speculators are not in the real estate game to acquire property for their long-term investment or shelter. Quite to the contrary. Like a **day trader**, they have no demand for the property, and similar to commodities dealers, do not take possession of it. They demand only the **temporary use of title** to the property as a tool to extract money from the market before the ultimate end user enters the equation and takes possession.

While the property is in the temporary hands of the speculator, it is effectively pulled from the market and unavailable to those who have an organic demand for it. Remember, speculators still have to find an end user buyer to purchase the property. Thus, the property will be returned back to the market for sale, as it was before, though offered at a far higher price. Thus, inventory is **deceptively reduced** below the level of demand.

Speculators are much like the unkempt agent who shows up late at a marketing session, *Twitters* until he makes his pitch, then departs, leaving nothing of value in his wake.

Speculators never intend to hold the property for the long-term, their involvement is kept to the shortest duration they can by design, much like a catch-and-release fisherman immediately returning his catch back into the water for the end user: the fisherman who will catch then actually eat the fish.

In terms of real estate parties, the speculator is more genetically similar to the role of a seller than that of a buyer. Even though the speculator purchased the property from the seller, what he is essentially doing is stepping into the shoes of the seller, a title he will officially don himself as soon as possible (immediately on a quick flip, or within about three months for a renovator).

Thus, the speculator isn't really buying the property from the seller – the seller is merely **assigning** the speculator the resale task of locating the ultimate occupant-buyer at a not-too-distant future date, the buyer being the only party who actually has demand for the seller's property. The speculator is a surrogate seller.

Thus, to acquire the sense of demand, you must look for the percentage of all sales which are going to an end user, not those reported sales maligned by the "parking" of property with an intermediary. With this rubric in mind, it is clear that lack of demand, not supply, is the real long-term obstacle blocking California's definitive ascent out of this economic morass.

**Life-cycle of a speculator**

The activities of a *speculator* are not synonymous with **demand** for real estate, and the second shoe of their distorting presence in the market is still to fall. When this time will come will be the subject of future conversations.

**Speculators** rely solely on an upward oscillating market to turn a profit on their investment. This means that in this **bumpy plateau recovery**, flippers will have a very long time to wait before a consistently rising market turns a sufficient profit to warrant selling at the dollar figure originally intended.

Thus, speculators who bought "cheap property" hoping for a quick flip at a higher price will have to adjust their modus operandi once they realize that prices will remain unstable through 2015-2016. Thus, these speculators will rely on their default fallback plan: hire a property manager (broker), rent the home and collect some income until they are able to unload the property on someone else. In this way, they will become landlords-by-necessity, a position which is not in any way consistent with their desired purposes for taking title to the property (or their skill set).

However, unlike before the Lesser Depression, they will find the market will not gain sufficient traction as quickly as the hit-and-run investor would like to resell at a profit (and function as a §1031).

In their impatience, as soon as they sense even the remotest bump in the market, speculators, acting in improvised unity, will all try to sell their *investment-turned-sour* properties at the same time. This collective activity will likely occur within one or two years' time.

This sudden flood of failed investment properties will be the second shoe to drop, and again exert downward pressure on the market. Ultimately, **end user buyers** must return at roughly double or triple the pace they're at now to begin soaking up some of this excess inventory as it again saturates the market.

# Chapter 34 The demographics forging California's real estate market

*This chapter examines the effect California's shifting age demographic has on future real estate trends, and provides insight as to how agents will benefit by anticipating the services needed to support the emerging real estate market patterns.*

| |
|---|
| ***Chapter 34 Outline*** |
| *Trends with opportunities for everyone* |
| *A housing market geared by Gen Y to accelerate* |
| *Gen Y: the nomadic demographic* |
| *What does this mean for California agents and brokers?* |
| ***Chapter 34 Terms*** |
| *Generation Y (Gen Y)* — *Labor force participation (LFP)* |
| *Great Recession* — *Real estate owned (REO)* |

**Trends with opportunities for everyone**

The *Great Recession*, like all other recessions that came before it, will have the effect of hitting an economic reset button. Trends in the real estate market, in ownership behavior and financial concepts that crystallized during the cash-flush years of the *Millennium Boom* ceased completely. These trends include:

- the belief in ever-increasing home-asset prices;
- the infatuation with suburban living;
- the arrogance of "as-is" type disclosures; and
- seller's agents' smugness about seller dominance.

In its wake, new market trends have taken root, sprouting in widely different directions like the arms of a newborn starfish, to grow with the greatly altered market based on realities of the post-Boom era.

In the period since the end of the **Great Recession**, California's real estate market has settled in an end to the *Lesser Depression* and our present "bumpy plateau" recovery consisting of low

sales volume and prices, currently expected to last until 2016. When recovery does arrive, it will be thanks to the market's cyclical nature, the state's favorable geography and its youthful and educated population — which includes native-born citizens and those here by migration.

But what direction will a regenerated real estate market take after shortsales and *real estate owned* (REO) resales which now dominate the conversation are fully purged?

What geographic regions of California and segments of its population will carry the action and be profitable for the real estate industry's gatekeepers in the coming years? What part of the real estate market will not survive the demographic shift, and will instead become rightfully extinct?

### A housing market geared by Gen Y to accelerate

California agents and brokers — our licensed and entrusted **gatekeepers** — will not likely bank a fortune in the years 2012 through 2016, but many will position themselves to acquire great wealth by the end of this decade. During the lean years of hugely reduced real estate sales activity — such as 2012, which saw one-half the sales volume of 2005 with properties moving at half their 2005 prices — most agents who remain active full time will only generate an income sufficient to support a minimal subsistence to perform as agents.

Thus, a collective decline of roughly 75% in personal income for California's real estate licensees handling sales has taken place since the Boom years of 2002-2006. This comes as a devastating financial blow to most. Agents and brokers engaged in **property management** have fared much better, especially in residential property.

However, forward-looking brokers and agents are planning for their future incomes. They are taking the time now to acquire the specialization needed to build their reputations and develop expertise in segments of the real estate market that are beginning to expand (while others are or will be contracting). Rebranded as **stand-alone experts**, they will be in an ideal position to profit when the market definitively rebounds.

The pace and quantity of new jobs will dictate the flow of future real estate sales volume and leasing since income is necessary to purchase and carry (or rent) a property, and to house employees, inventory or family. Thus, the future of real estate can be divined in part by:

- looking into *employment trends* — jobs going forward; and
- *labor force participation* (LFP) rates, the percentage of the population currently employed or actively seeking employment.

Like peering into a crystal ball, a critical study of **LFP** rates predicts the future movement of the California real estate market. However, some knowledge of California's **age demographic** is fundamental to understanding and predicting LFP rates. Simply put, while jobs drive real estate transactions, it is demographics which initially drive job creation and LFP rates — which in turn drive real estate sales and rental occupancy.

For example, the low LFP rate among this decade's 25-34 year olds, known as *Generation Y* (Gen Y), indicates this segment of the population will enter the real estate market as first-time homebuyers later than prior generations. Generation Y is taking more time than its Boomer parents to accumulate the wealth (down payment) necessary to purchase a home, an amount equal to 20% of the purchase price.

At the other end of the generational spectrum, a high LFP rate is presently being experienced among the generation aged 55 and above, indicating that this older generation, while growing fast in numbers, will work longer before they retire. Thus, they will likely delay the sale of their current home (most purchased in the 1985-1991 period) and the ensuing relocation into another home beyond this decade.

LFP rates, by demographic, are the focus of *Labor Force Participation and the Future Path of Unemployment*, a recently published Economic Letter by Joyce Kwok et. al. of the Federal Reserve Bank of San Francisco (FRBSF). Though the study deals exclusively with employment and demographic trends, **first tuesday** extrapolates this data and interprets what it means for California real estate agents, supplemented by data released by the U.S. Census Bureau (the Census).

**Gen Y: the nomadic demographic**

Gen Y is taking longer to settle down and is remaining transitory, both economically and physically, longer than prior generations. 33% of 20-year-olds now migrate to a different rental property every year, while 40% move back in with their parents at least once over the course of their early adult lives, according to 2009 data released by the Census.

Gen Y is also professionally untethered: the average person in Gen Y goes through seven jobs before they reach the age of 30 — the median age for first-time homebuyers.

**Employment**, more specifically an existing job, is the first and most integral step toward real estate acquisition by younger age groups. To purchase a property at age 25-34, the typical age of a first-time buyer, individuals in Gen Y need to borrow against the future income they will receive. This is a prudent thing, since they benefit from a higher standard of living today, paid for with future earnings (which, presumably, will grow — unlike in the 2010s — and allow an even higher standard of living in the future).

However, the **Great Recession** has stifled Gen Y's career development, permanently stunting the financial well-being of these recent college graduates and **delaying** their entry into the real estate market. That has been a career killer in other countries experiencing this sort of delayed job recovery since it greatly reduces their future incomes and standard of living — housing.

Lower-skilled adults aged 18 to 34 experienced the most pronounced increase in poverty in 2009 versus other age groups, according to the Census. This age group is composed of the Gen Y children of the Boomers. Many members of Gen Y cannot now find any form of employment upon graduating high school or college. Most find it harder yet to get a job in the pre-selected field of study they pursued in academia.

Thus, most in Gen Y settle for a job in a different discipline, **professionally stigmatizing** them for later entry into their industry of choice; at best, delaying the age at which they will attain pay levels consistent with their desired standard of living.

Additionally, due to the lack of long-term professional experience among Gen Y, many shell-shocked employers are spooked by the recessionary cycle and retain and hire only older workers since they have already proven themselves proficient at the jobs available.

Without an income flow from employment to develop savings, Gen Y has no immediate access to funds for a down payment on their first home, let alone the financial resources necessary to service the continuing costs of ownership. Similarly, without a job, the inverted **debt-to-income (DTI) ratio** of Gen Y will render them ineligible for purchase-assist financing, a condition referred to as *financial atrophy*.

This diminished economic standing of Gen Y has temporarily reduced the demand for housing. Many unemployed members of Gen Y have been forced to move back in with their parents in the suburbs, or to cohabitate with friends or romantic partners.

**What does this mean for California agents and brokers?**

The future will bring buyers, but it will take patience to wait until Gen Y is in an economic position to enter the fray. For California agents and brokers to position themselves to be of service to the home buying Gen Y, real estate professionals need to understand the psychological, social and financial conditions of this first-time buyer age group. An intimate level of knowledge about Gen Y will be most helpful when dealing with their unique background.

**first tuesday** predicts Gen Y will suddenly "get it," and will come to understand that homeownership is a socially, if not financially, advantageous thing to do — the *luxury versus necessity debate*. Once this synchronized realization takes place, the rush will be on, just as it was with their parents in the late '80s, although it will be tempered by Gen Y's experience and observation during the Great Recession.

# Chapter 35 — The bumpy plateau recovery

*This chapter describes the "sticky price" phenomenon afflicting sellers of real estate, and how faulty pricing is a drag on the housing market during recovery periods.*

***Chapter 35 Outline***

*A side-effect of sticky housing prices*
*The reality of home prices in California*
*Agents: opponents of money illusion in seller pricing*
*Sticky prices, a jobless recovery and flat-line prices*
*Sellers and their sticky prices*

***Chapter 35 Terms***

| | |
|---|---|
| *Broker price opinion (BPO)* | *Money illusion* |
| *Comparable market analysis (CMA)* | *Sticky price phenomenon* |
| *Consumer price index (CPI)* | |

**A side-effect of sticky housing prices**

Consider the owner of a home located in a neighborhood which has its share of foreclosed properties flowing from the *Great Recession*. He now wants to relocate, but must sell his property to do so.

The owner contacts a real estate agent to discuss entering into a listing agreement to sell the house. The property will show well, as the owner kept it in good repair and made minor improvements to upgrade the property's appearance.

The seller's agent inquires about what price the owner will accept for the property. The owner feels buyers should pay an amount like-type neighboring properties sold for during the recent peak in prices. He claims home prices do not fall and never have since a home is a safe investment. His sense is current resale prices paid for *real estate owned* (REOs) *properties* are the result of forced sales and are not comparables for setting fair market values.

The agent's *comparable market analysis* (CMA) prepared for the listing interview contains the three most recent sales in the immediate area, all of which are **REO** resales. Other privately owned homes in the area are on the market in the multiple listing service (MLS), but none have sold.

With this **CMA** presentation, the agent is unable to temper the high price the owner believes he should receive. However, the owner says he wants to sell, and the agent is able to list the property at the price sought by the owner. [See **first tuesday** Form 318]

The property sits on the market, unsold for the duration of the listing. The owner will not consider a reduction in the listing price in spite of his seller's agent's counseling efforts. Meanwhile, his property's market value continues to adjust downwards under the reality of the region's demographic situation. The listing becomes shop-worn, and no one looks at it.

**The reality of home prices in California**

During the **Great Recession**, home prices throughout California took a nosedive coming back into line with the inescapable historical trend in real estate asset inflation **California's real estate microcosm** a price path parallel to *consumer price index* (CPI) figures. Property prices are time and again pulled back to trend lines by the fundamentals of consumer price inflation.

Homes and other improvements on land comprise only the efforts of labor and the supply of materials, the subjects of consumer price inflation. The value of the land has a current price based on inflation, development restrictions and local demographics (read: population density and income).

This inflation trend-line magnet is especially noteworthy in California. Here, the land component of a home has a century-old geographic premium already built into its trend line price, subject to variation by location due to changes in population density and earnings — demographics.

Further, California property is evaluated and priced in terms of the U.S. dollar. Thus, in keeping with the loss of purchasing power due to monetary inflation, prices will increase steadily as reflected in annual **CPI** figures.

Accordingly, the long-term pricing trend line suggests whether actual sales prices at any moment overstate or understate that value to which the property is anchored. Underlying all real estate pricing is the effect of rental rates tenants will pay for the property and the long-term capitalization rate (itself a product of the rate of inflation), primary fundamentals for setting income property asset values (further limited by lesser replacement costs or comparable sales prices).

The current property price correction is still ongoing in 2011, and will take not months, but several years to develop a consistent level of price increase.

The time period from peak prices, then on to growth and inflation adjusted prices, is needlessly extended due to sellers' unwillingness to let their brokers and agents set the present price of a property. With listing prices set close to current market value as demonstrated by the agent's CMA, property can be sold in roughly a two-month marketing period. Otherwise, it stagnates under an ever-aging listing while property prices move lower, remain the same or follow the 2%-3% pace of consumer inflation.

A home's fundamental purpose is simply as a shelter; a source of wealth produced by equity buildup through the monthly amortization of principal in what is a compulsory saving program managed by mortgage lenders. All goes well if prices paid for properties do not exceed historical trend line values, i.e., they were not purchased during periods of excess in the economy, which would keep prices from rising at an unsustainable clip.

The radical upturn in price increases experienced between 2002 and early 2006 did not come about in a day or two, but took ten years from the initial signs of **irrational exuberance** observed by the Federal Reserve (the Fed) to the bubble implosion. Even in less severe real estate market corrections, sellers are the very last to capitulate to the downward price correction. Thus, sellers dismiss the fact of lower property prices and live under the *money illusion* of prices paid in the past, also known as the *sticky price phenomenon*.

**Agents: opponents of money illusion in seller pricing**

In a recession, a home's cash value is limited by the amount of its replacement costs and the land price paid as dictated by the demographics of the population in the area surrounding the property. Replacement costs for most properties tend to be less expensive in recessions following a period of excessive construction activity.

Fabricators and vendors of construction materials sharpen their accounting, and labor bends to lower pay, to say nothing about the availability and price of what then has become non-productive land. Thus, replacement costs are also driving down the price of real estate from yesterday's experience, and have not yet settled down and become fully determined.

Likewise, as is the case with many financially-distressed regions of California, neighborhood demographics tend to shift from owner-occupied to vacant or tenant-occupied. This shift is accompanied by a downgrading of care in the upkeep of properties, which in turn contributes to the deterioration of neighborhood amenities and property values.

Add to these economic forces the glut of bank-owned properties in competition with existing homes for sale by positive-equity homeowners, and the result is the California mortgage disaster that will not abate until around 2016.

Understandably, owners with properties in such circumstances do not want to acknowledge that market factors do influence the price buyers will pay for their property. It may be a matter of employing mental blinders, or merely a stubborn (conservative) resistance to changing circumstances, but it is paired with irrational hopes of beating the odds.

The seller's agent must determine whether the seller understands the probable price an informed buyer with a competent buyer's agent will pay. Further, the seller must be ready to accept a realistic offer. If not, he is merely using the seller's agent's efforts and money to search for that elusive unprotected and emotional buyer in order take in a windfall profit on a high asking price.

However, unreasonable expectations are created or allowed to persist when seller's agents do not advise their sellers by providing their opinion of value known as a *broker price opinion* (BPO), evidence of pricing by a CMA and the reasons why that price should be used to set terms in the listing.

Instead, seller's agents most often passively enter into listing agreements and allow their sellers to use their arbitrarily high price (or worse) as the asking price at which the agent and his broker have a duty to market the property.

While it is the agent's job to get the best price he legally can for his seller, there is no benefit – neither in the form of a closed sale nor a broker fee – when the listing price is set too high for the market. The continual need to reduce the listed price to catch up with the market wastes not only the seller's agent's time, but the seller's.

When sellers are truly ready and driven by a need to sell their homes, it is the agent's job to market the property for sale at a price which will attract an offer within the first days of a 90- to 120-day listing period.

The agent and his seller must have a rational conversation, in which the agent breaks down the **money illusion** set in the seller's mind by past prices, if the agent is to carry away a listing agreement employing the agent to locate a buyer at present market prices.

To get this conversation under control so the agent's decision to list or not to list can be made, it must be based on a review of a CMA worksheet prepared by the agent in advance of discussions about entering into a listing. [See **first tuesday** Form 318]

Discussing comparable property sales with a seller provides the seller with the basis for a realistic notion of how his neighborhood's property prices are performing. The agent should also take care to explain the ramifications of pricing property above the market, e.g., there is more than a slight chance that the listing will take longer to sell, maybe years.

This information is crucial to a seller who is motivated to have a property off his hands. Some are; some aren't. The seller's agent's job is to determine which type of seller he is dealing with.

**Sticky prices, a jobless recovery and flat-line prices**

Predictably, sticky prices are only an issue when the market is moving downwards. Owners are eager to raise prices when they think real estate prices are improving.

However, the media often misleads property owners by hyping movement in the *median price* — but seller's agents know the **median-priced home** doesn't exist. The median is a phantom figure, a mathematical abstraction that does not reflect the price or price movement of any parcel of real estate, neighborhood or marketplace. Sellers need to understand this. This distracting conversation is one most agents will have to patiently endure.

Remember also that the 2007-2009 Great Recession belatedly began to reduce home prices in response to a past market correction which was aborted in 2001 when the Federal Reserve (the Fed) suddenly reversed course and dramatically dropped interest rates in a monetary response to the September 11, 2001 attacks. Thus the ensuing boom in real estate was artificially created to thwart the perceived potential financial disaster inflicted by 9/11.

A few years into the artificially-induced *Millennium Boom* — so flush with easy credit and its speculative influence — it was taken for granted that constantly higher property prices, the increasing production of goods and services and the steady creation of jobs were here to stay without the need for correction. We now understand, as many thoughtful individuals did then, that they were not.

House sale volume and prices were aided in 2009 by government intervention in the form of **tax credits**. The primary purpose of the subsidies was to sell REOs and builder inventory. Loan modifications were encouraged under the *Home Affordable Modification Program* (HAMP) to keep slightly underwater homeowners (with LTVs under 125%) from foreclosure and REO inventories low, and thus had little effect in California. But the crux of the housing issue (and indeed, the California economy) in the coming years is jobs — new employment opportunities.

The high number of jobs lost in California (10%) following the employment peak in December 2007 will take until 2016 to regain. These lost jobs, in large part never to be replaced (excess construction), and the slow rebuilding of new and different industrial, service and professional jobs will have an initial oppressive effect on the recovery, keeping it from any sort of immediate upward climb.

Instead of a typical W-, V- or U-shaped recovery, this recovery is pictured as an *aborted checkmark-shaped recovery*, bouncing off the bottom of the 2008 recession as it has, then flat-lining on a bumpy plateau for several years.

**Sellers and their sticky prices**

As long as the unemployment and under-employment rates in California remain high and overtime hours remain low, sellers will see an effective ceiling on the prices they are able to command for their properties. Very little improvement has been made in these three employment conditions as of late-2011.

Buyers and tenants need jobs to pay for shelter. Instead of seeing an ever-higher improvement in property prices, agents will be faced with a second round of sticky prices — this time in anticipation of price improvement that has been long in coming — 2013-2014 and beyond.

This depression in real estate activity is not the result of a Fed-orchestrated business recession designed as a temporary interlude to cool the economy and let it firm up for further growth. Peak 2006 real estate prices will not return for a generation (2025) and many of the lost jobs from the boom period may be gone forever.

Eventually, lost jobs will be replaced with long-term employment in durable industries and services dependent on a steady-as-you-go economy. The Fed, congress and the treasury are presently being forced to collaboratively engineer this job environment.

If this checkmark-shaped recovery remains as anticipated, agents need to be prepared to once again take up arms against the **sticky price phenomenon** and get pragmatic with their sellers. During the coming years of flat real estate prices, agents need to consider the factors which temper the price a seller seeks for his property, including:

- a second wave of foreclosures and REOs in the cards for 2011 and on into 2014 or further, as a significant portion of the mortgages in California (even those that were modified) are delinquent and thousands of others are going to reset and be defaulted on including modified loans;

- potential buyers who currently hold jobs remain reluctant to purchase when they feel unsure of their job or pay status;

- consumer confidence numbers for homebuying conditions are still far below normal, despite the recent rise in homebuying sentiment levels about future major purchases;

- *buy-to-let investors* (and failed speculators) are making a comeback in the 2011 market and are again, as after the 1990 recession, creating rental neighborhoods which will create static or sagging market values;

- buyers do not yet sense any competitive drive to buy as happened in the 1996-1997 period following the 1990 recession after prices had remained flat for six years; and

- mortgage rates are most likely to rise by 2014 as banks get back to lending and the national and state economies start to fire up, which will put downward pressure on real estate prices (as they did in 1984 and 1994) since **buyer purchasing power** will be cut by the higher interest rates which reduce the amount they can borrow.

California real estate agents and brokers, as the **gatekeepers** to our world of real estate, must bolster themselves for the long haul in view of all these conditions.

This includes taking steps to ensure their sellers' goals are set at levels that can be met to produce sales and move the inventory.

In the market of 2012-2013, the goal set must reflect the pricing reality of the real estate marketplace, highlight the amenities in the sale of an otherwise most commonplace item (a principal residence) and avoid treating the home as a quasi-investment (unless the buyer is a buy-to-let investor and then a full income property analysis is necessary).

# Chapter 36 Rentiers and debtors: why can't they get along?

*Current U.S. financial policy sustains an unbridgeable gap between the demands of those who owe and those who are owed. This chapter explains why things didn't have to be this way.*

***Chapter 36 Outline***



***Chapter 36 Terms***

*Collateralized debt obligation*
*Credit default swaps*
*Debtor*
*Financial crisis*
*Mortgage-backed bond*
*Quantitative easing*
*Rentier*
*Residential mortgage-backed securities*
*Trickle-down economics*

**The world of passive entitlement**

Consider a large and powerful Wall Street investment bank. In the years leading up to the 2008 *financial crisis,* the bank creates $100 billion worth of tranche-complex and high-risk *mortgage-backed bond (MBB) investments*.

Designed for public consumption, MBBs are comprised of *residential mortgage-backed securities (RMBS), collateralized debt obligation (CDO) securities and credit default swaps (CDS).*

The bank sells most of the bonds to unsuspecting investors, without disclosing the high risk of loss that accompanies them. Then comes the **financial crisis**, causing homeowners to lose both jobs and property values, bringing on an unsettling number of mortgage defaults.

To maintain its profits and the fortunes of its MBB investors, the banker advocates public policies – such as low inflation, financial bailouts and subsidies, expansive monetary policies (including quantitative easing and depressed interest rates) and fiscal policies socializing private banking losses.

**Prolonged suffering**

These policies, however, prolong the suffering of mortgaged homeowners as the bankers prosper.

This is, of course, the well-known story of Goldman Sachs, but almost every other major Wall Street brokerage and every major bank (and, therefore, every major mortgage lender) has a similar tale to tell; mortgage borrowers misled, bond market investors defrauded, illegal foreclosures, retaliatory FICO scoring and insider bets against housing loans.

Most recently, in July 2011, Bank of America set aside $14 billion to pay MBB investors for unsanctioned securities trading.

Illegal? Possibly. Unacceptable behavior? Certainly. But at this point is anybody really still surprised by stories of lender abuse?

More to the point, is anybody surprised by the fact that while the borrowers who make up a preponderance of the U.S. population continue to suffer a reduced standard of living due to high unemployment, most abusive lenders continue to succeed and even thrive economically?

Citigroup reported profits of $3.3 billion in the second quarter of 2011, and Bank of America would have done similarly well had it not been forced to pay for the extensive legal troubles of its mortgage lending department.

The fact is, lenders are merely working in their own best interest—and their continued financial success indicates that their strategies are effective.

**Different laws for different classes**

In a much-blogged-about June report on *creditslips.org*, Robert Kuttner draws the distinction between the *rentier class*, made up of those who lend money or let real estate, and the *debtor class*, comprising those who borrow or rent. The **rentiers** exist **in opposition** to renters; the latter pay, and the former collect.

Rentiers, Kuttner points out, are largely governed by the laws of large for-profit corporations, which entitle them to participate in behavior forbidden to individual members of the general public.

At the bottom of the bankers' advantage, Kuttner says, is a fundamental contradiction. Banks are given access to money at extremely cheap rates by their unique ability to borrow from the Federal Reserve (the Fed), the initial source of all U.S. currency.

To stimulate spending in this recession, the Fed has consistently lent money to banks at essentially zero percent interest rates. In return, the banks are expected (though not required) to increase their own lending to private borrowers.

**It's just corporate business strategy**

Meanwhile bankers are able to escape their debts by passing them on to the **Federal Deposit Insurance Commission (FDIC)**, or, in extreme circumstances, by receiving massive government bailouts (recapitalization) funded by the **U.S. Treasury**.

When banks escape financial obligations they are unable to pay due to their own mistaken calculations and harmful behavior, it is considered a legitimate corporate business strategy.

In contrast, mortgage-holding homeowners are left to repay their mortgage debt, as bankers steadfastly resist any congressional attempts to make it easier for homeowners to escape even the most egregious amounts of debt.

When homeowners push for the same right as banks, through *cramdowns* orchestrated in bankruptcy court or by just walking away from an underwater mortgage, the decision to escape debt is at best called a moral failure and at worst a legal impossibility (although not in *antideficiency* states, like California).

As a result, the nation is divided into two separate and adverse **economic classes,** each of which depends upon the other. *Class warfare* seems to be the inevitable result of this dichotomy, but the economy has not always been so clearly divided.

In reality, it is not at all difficult to envision a society in which the interests of **rentiers and borrowers** are far more closely aligned. To understand how this is possible, a clearer definition of the term **"rentier"** is required.

**Who are the rentiers?**

Rather than referring to a "lender class," it might be useful to think of the **rentiers** as all those who receive fixed income yielded from tangible and intangible assets they own. While most of our population derives its income from the direct production or sale of a good or service, rentiers profit by **passively earning income** generated by a possession.

For example, a mortgage held by a lender or an apartment/nonresidential property held by a property investor (as in passive and portfolio income tax category investments) make the owner a *rentier.*

On the reverse side of the coin are businessmen, professionals and employees, who are active and earn money for their efforts, as well as speculators (day traders/flippers), who buy and sell property or other assets and profit on the resale. They must go to work each day if they are to have an income flow, since they have not built up wealth which produces income independent of their efforts.

## Lords and serfs

It is not wholly misguided to think of the rentier class as the **lords** to a set of modern day **serfs**: the debtor class.

The serfs work to gain income to pay for their needs, and their standard of living is set by the success of their efforts. They depend upon their lord for resources, especially shelter. Of course, their labors also go to enrich the idle but moneyed property owners who provide land and protection.

The arrangement is sometimes necessary for the serf — he needs a safe place to grow his crop — but certainly tends to work out better for the lord. Theories such as *trickle-down economics* suggest that an increase in the strength of the lord will lead to an increase in the serf's well-being, but evidence has shown time after time that this is not the case.

The political success of the rentier regime in the current post-recession, financial crisis economy, Kuttner says, is indicative of an overall reversal in economic policy from the Keynesian economics in force at the close of World War II (WWII).

In that period, the dominant group (the U.S. and allied forces) considered demanding overwhelming repayments from the defeated nation of Germany. However, they instead listened to the advice of John Maynard Keynes, whose Bretton Woods monetary system "emphasized domestic recovery for the defeated as well as the victorious powers." We grow together from the ruins.

Thus, "a global monetary system was created at the end of WWII in which private financial speculators were denied the power to compel nations to pursue deflation" to pay war reparations.

Rather than the victors paying their vast war debt with money demanded from the defeated, the Fed tightly regulated the financial markets to reduce speculation and dramatically lower interest rates.

The results were economically beneficial for both the defeated and the victorious: a monetary *Marshall Plan*.

## Conflicting philosophies

In an ideal government, the conflicting demands of separate political contingencies—the few rentiers and the many debtors—would be balanced to the benefit of the largest contingency.

The *austerity measures* that are most beneficial to rentiers would be voted against by the much larger group of debtors, made up especially of homeowners, who will benefit from economic stimulus and tighter regulation of lenders. Since the debtors are a huge part of the working population that actively creates items and provides services for sale, the government has an **additional incentive** to insure their continued well being.

Clearly, this is not the case in the U.S. today. The current political conversation is dominated by calls for reduced benefits to lower-income earners, increased austerity (reduction) in government spending, reduced taxes on the wealthiest and extensive precautions against perceived future inflation.

**Entrenched rentier dominance**

Nobel laureate Paul Krugman is one persistent critic of the extent rentier dominance has taken hold in contemporary U.S. and international politics.

Krugman and other economists complain that establishment economic policy, which is predisposed to ensure that debts of individuals are honored rather than forgiven or artificially reduced by temporarily high inflation, is misguided and even harmful under the tenets of Keynesian economics.

After all, the **increased purchasing** — of manufactured goods, services and resale homes — necessary for the economy to recover cannot take place when a vast swathe of the population’s income is diverted from the purchase of goods and services to repay principal and interest on underwater mortgages.

This is not to say a secret cabal of rentiers controls U.S. politics. We do suggest, however, that the ideology of the rentiers has ceased to be limited to ideology held by a wealthy elite. Instead, it has insinuated itself into mainstream political thought like an invasive species.

**Wall Street versus Main Street**

As a result, the rentiers as a class continue to be among the very few to reliably achieve continued financial success in this period of economic stagnation. However, rentier-friendly policies unavoidably pit Wall Street bankers against the needs of Main Street individuals.

Kuttner compares economic policy in the U.S. and the European Union, both of which currently emphasize the unaltered maintenance of debtor obligations (whether they be owed by homeowners or by bankrupt European nations), to the disastrous punitive reparation policies of Britain and France toward Germany after the World War I (WWI). The result in that case, as Keynes then predicted, was another war.

The inadvertent result of current world policy, which sets the interests of debtors against those of creditors, is a different form of conflict: **class warfare.**

**Opposing views focus attention**

Complicating the issue is a recent report by *The Economist,* which counters Krugman’s description of the current policy situation.

It argues that Krugman’s advocated policies of higher government spending, through programs like an expansion of the Fed’s recent bond purchases (called *quantitative easing*), are actually no more likely to help debtors than lenders — that is, the distinction between the two, from a monetary policy perspective, is **illusory**.

*The Economist* claims “sound money” and “balanced budgets” in times of financial crisis are the defining elements of historical rentier dominance. It supports this claim by reference to the presidency of William McKinley, which was based on maintaining the gold standard and low inflation (Britain did the same after WWI).

*The Economist* contrasts that period of rentier dominance with the current Administration: “two years of quantitative easing, huge budget deficits and negative real rates. 19th century central bankers would regard this era with anathema.”

**The effect of quantitative easing**

Federal stimulus projects enacted thus far have indeed done very little to improve the long-term status of homeowners threatened by foreclosure. The recent and ongoing rounds of **quantitative easing**, which are advocated as necessary Keynesian stimulus to repair the economy, have also had the direct, immediate and pronounced effect of bolstering share prices and commodities markets, but not real estate assets.

The sole present beneficiaries are Wall Street bankers and executives — the rentiers — rather than troubled Main Street homeowners with negative equities and few prospects for more jobs.

Essentially, these projects are neither properly directed to assist mortgaged homeowners nor sufficiently extensive to make an immediate difference.

The policies which would be most valuable to all of society’s participants, and which we are least likely to see, are those which lead to **debt forgiveness**, even at the rentiers’ immediate expense.

Foremost among these options is temporarily increased inflation, which the Fed can easily manage, as well as the much discussed principal cramdown of mortgage debt to the value of the home it encumbers, which could be addressed by a responsible and focused Congress.

**A harmful artificial distinction**

While debtors and rentiers are always troubled by conflicting interests, the current state of conflicting policies is the result of a peculiar set of regulations that apply to banks. Economic blogger Steve Waldman points out that “banks, after all, are not only creditors. They are also the economy’s biggest debtors,” since all deposits they hold are amounts they alone owe their depositors, although guaranteed by the U.S. government.

In a **rational world,** without the assurance (if not implicit guarantee) of government bailouts, bankers would be as concerned about their own risk of insolvency and bankruptcy as are the homeowners whose mortgage debt they hold.

The advocated solution is a removal of policies which grant *artificial security* against loss to bankers while denying similar security to homeowners. Such harmful policies include bizarre accounting regulations and the implied guarantee of bailouts behind the “too-big-to-fail” mentality.

**Troubled assets obscured**

These **fiscal policies** make it easy for banks to obscure their troubled assets from investors (as well as the lack of regulation that makes abuses, like Goldman-Sachs', possible), which of course they do.

That is, rentiers — like homeowners — should know they are at risk of foreclosure by the FDIC if their debts (held by depositors) are not repayable from the value of their assets.

It is important for homeowners to remain aware of which class — rentiers or homeowners — stands to benefit from future changes in fiscal or monetary policy, including those changes which are ostensibly enacted in support of the homeowner.

The pace of the economic recovery and the long-term personal financial success of all mortgaged homeowners depend upon the outcome.

If the huge debtor class of homeowners is to preserve its ability to recover from a general financial crisis and create a future for itself collectively, it must emulate the bankers and rally to advocate political positions which allow it the same privileges rentiers take for granted.

Perhaps most essential among these privileges is the guilt-free ability to legally walk away from mortgage debt, since within their own households, every homeowner is 'too big to fail.'

# Chapter 37 — 30 years of summer, followed by 30 years of winter

*This chapter discusses the cyclical pattern of rises and falls of interest rates, and makes the case for a future of real estate pricing characterized by ascending mortgage rates.*

***Chapter 37 Outline***

*Bond market cycles*
*Interest rates and asset pricing*
*Interest rates in the modern day*
*The next three decades*

***Chapter 37 Terms***

| | |
|---|---|
| *10-Year Treasury Note* | *Greenspan Put* |
| *Core inflation* | *Rentier class* |

**Bond market cycles**

**Interest rates** on the *10-Year Treasury Note (T-Note)* yield have shown a slow but steady overall decline since 1980, following a rise from lows last reached in 1941. [See Figure 1]

We can now see that 1940-1950 marked the beginning of what has become a 60 year rates cycle: approximately 30 years of rising rates, followed by 30 years of falling rates. This roughly mirrors the 60-year period prior to1950, in which interest rates peaked in 1921.

Going forward for the next roughly 60 years, **first tuesday** expects another slow upward run in rates for 20-30 years, and then a reversal into rate declines as occurred following 1980.

The interest rate on the10-Year T-Note dropped as low as 1.47%  in early June 2012 as the euro, the renminbi, and the Brazilian real all weakened against the U.S. dollar. These lows are extreme and are evidence of international monetary stress.

But with global economic chaos, highlighted in Europe, China, India and Brazil, the non-responsive U.S. jobs market, and the flight of cash into U.S. dollar-denominated liquid assets (bonds), we have likely not seen the lowest point in the trough of this long-term interest rate cycle.

This cycle's bottom for *10-year T-note rate*, which has declined since 1980, is yet to be found. Since mortgage rates have historically moved in tandem with the 10-year T-note at a 1.4% spread, it is likely that home loans will also remain cheap for the immediate future.

As **first tuesday** has previously reported, current real interest rates on 10 year T-Notes are at or near their *zero-bound*. They **cannot fall** further unless the Fed goes negative, which it will not

do without severe cause. As a measure of financial security returns to the market in upcoming years, rates at some point will start to rise, and mortgage rates will begin running up at the same time.

Furthermore, the upcoming period of rising rates is likely to last for quite a long time – two or three decades.

The last three cycles in bond market rates have been extremely regular, points out Chris Watling of Longview Economics. A 29-year downtrend in rates (1920-1949), followed by a 32-year up-trend (1949-1982) and another 31-year downtrend lasting to the present.

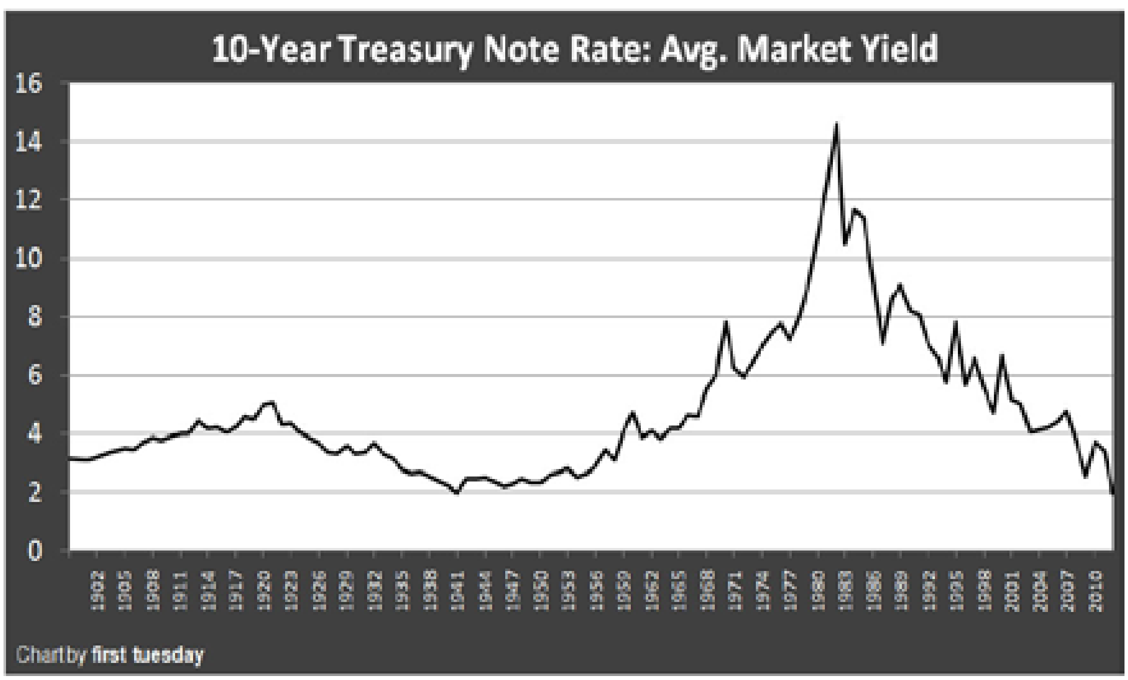
While the regularity of this pattern of 30-year passages should be considered coincidental (they very easily might have been forty years, or twenty), precedent establishes that bond market rate changes are much slower and more gradual than, say, changes in the stock market.

**Interest rates and asset pricing**

In previous interest rate cycles, rates rose for approximately thirty years, peaking in 1927 and again in 1979 after rising from essentially zero in the late 1940s, following the recovery from the Great Depression.

In 1947, at the end of World War II, interest rates on the 10-year T-Note were near zero, much as they are today. Then, from 1947 to1979, rates moved steadily upward.

**Figure 1**



1947 is a key year for other reasons as well: it marked the end of a recession, and a long-awaited return to prosperity after the Great Depression of the late-1930s. If this interest rate pattern holds true, as **first tuesday** believes it will, we now find ourselves at the beginning of a reversal in the real estate market comparable in type, if not in intensity, to the turnaround after 1947.

During the resulting half cycle of rising interest rates from 1947 to 1979, the wealth of investors increased even as interest rates rose, housing construction was very strong and employment and prosperity increased as well. The *American Dream* of jobs, cars and homes for all was in full bloom during this period. We expect to experience similar conditions during the two or three decades, into the mid 2030s – once we get out of this *Lesser Depression* (this time, hopefully without the stimulus of a war effort).

For the housing market, however, rising interest rates, even static interest rates, mean that there will be no short-term profits to be had from any increase in pricing. The notorious *"Greenspan Put,"* which we have grown accustomed to seeing after every drop in interest rates, will not and cannot be repeated to artificially generate profits in any asset market – commodities, stocks, bonds or real estate.

Mortgage rates are inextricably tied to bond market rates, and every increase in bond and mortgage rates means a decrease in a homebuyer's purchasing power – the amount he can borrow based on repayment at 31% of income – and an increase in the earnings of the *rentier class*. Thus, a buyer will experience a decrease in the amount he can pay for a home.

Less money borrowed by homebuyers means less price received by sellers for their properties. Of course, this annual decrease in purchasing power is fully offset in actual (nominal) dollar terms by the Fed's monetary policy, which maintains annual inflation around 2%. This inflation is the driving force increasing wages from year to year.

As in the period of rising bond and mortgage rates from 1949-1980, prices will be held down, rising only in response to consumer inflation as permitted by the Fed and any "price appreciation" at the property's location (appreciation occurs solely due to demographics, as **demand** for real estate within an area increases with a rise in the area's population density or an increase in the income of that population beyond the rate of inflation).

### Interest rates in the modern day

Today the economy remains mired in what some economists have termed a **Lesser Depression**: a period of ongoing joblessness, debt deleveraging, increased savings and low income that in many ways exhibits the symptoms of an actual depression. This period has not paralleled the several garden-variety recessions of the past 60 years. To combat the lack of available money, the Fed has all but exhausted its strongest tool: the ability to lend endlessly at ever lower rates.

For the first time in sixty years, interest rates have once again reached zero. 10-year T-Note rates have remained near 2% since late-2011: an interest rate that should be considered approximately equivalent to a zero *real rate* since a sustained *actual rate* of lower than 2% will be too low to cover the standard 2% rate of *core inflation* which annually lowers the purchasing power of the dollar invested in the bonds.

In spite of government guarantees, home mortgages are a riskier investment than treasury bonds. Mortgage rates are thus typically priced at a 1.4% margin over the rate on 10-year T-Notes. Under this historical margin, mortgage rates should currently be at around 3 %, not the 3.7% to 4.1% range they have occupied for the past nine months.

The fact that mortgages cannot drop further than the rate on 10 year T-Notes plus 1.4% suggests that mortgage rates are now essentially at zero. They will not drop lower unless the Fed "goes negative," namely paying private banks to lend to the public.

In such a hypothetical "negative rate" scenario, the Fed would go so far to stimulate lending as to accept repayment at a rate lower than zero (i.e., lend one dollar to be repaid at 97 cents, a negative interest rate of 3% per annum). Going negative will be necessary only if dramatic further stresses are imposed on the jobs in this economy.

**The next three decades**

When bond yields hit their bottom in the late 1940s, they remained low for a period of eight years. While bond yields have now reached a low in actual rates, and hence a long-term peak in homebuyer purchasing power, it is likely that we will have until 2015 before rates begin to rise gradually.

When rates rise, agents will quickly learn to cope with an unfamiliar set of investment and pricing challenges (including different income multiplier/capitalization rates, long-term holding periods before profits can be taken, and Due-On Sale clause assumptions). The key lesson to remember in those upcoming years will be that real estate is most properly priced and held for its **inherent rental value**.

Those who buy property for speculative gain, not rental income, will see as little success in gains from a flip as those who invested in the real estate market from 1950 to 1980, when mortgage rates moved slowly, steadily upward until they exceeded 18%.

The next peak in rates, whether or not they reach past heights, will likely take another 30 years to arrive. But this cycle's days of steadily decreasing interest rates, accompanied by steadily falling rents, producing ever increasing prices and profits (and §1031 hysteria) have run their course to the bitter end.

In the last two decades, it was possible to purchase a parcel of real estate, vacant or improved, and tale a profit, much greater than the rate of consumer inflation, merely by holding that parcel for a short period of time. This is no longer an option. Prices may rise in narrowly defined locations enjoying a population density explosion, but most will be dampened by constantly rising interest rates which will keep prices from rising faster than the rate of **core inflation**.

The negative pricing effects of increasing interest rates can be at least in part counterbalanced by improved zoning. If property prices rise beyond the rate of inflation, local governments will have to permit density to increase to accommodate those who are attracted to the area or suffer the consequences of an asset inflation bubble. Smart investors will look to purchase property in urban centers which have already begun to establish themselves as the most desirable abodes for the next generation of homeowners and tenants.

In the long run, investors in real estate will need to increase their wealth, not by flipping their properties for profit, but by generating rental income over the course of long-term ownership. Income property will be bought to be operated and managed for an annual net operating income, capitalizing at the rate proper going forward.

In boom times, property owners were accustomed to capitalization rates (cap rates) of 6% or less. For upcoming years, 10% may be more normal. Prudent property selection, careful research, forward looking capitalization rates and a long-term commitment to real estate ownership will be the keys to success in the **new paradigm**.

# Chapter 38 The timing and strength of the economic recovery

*This chapter comments on whether California's recovery following the Millennium Boom, the Great Recession and the financial crisis can be predicted by studying post-World War II recessionary and recovery cycles.*

***Chapter 38 Outline***

*Divining the future from the past*
*Regional exceptions*
*The future for California*

***Chapter 38 Terms***

*Great Recession* *Millennium Boom*

**Divining the future from the past**

Few would dare question the severity of the *Great Recession*, which officially started December 2007 and ended August 2009. Trillions of dollars in personal wealth evaporated nationally in home values.  Along with this loss, California lost all the jobs created during the 2000's — 1.5 million.

Though its severity is unanimously acknowledged in California, less consensus has been achieved regarding the details of our eventual recovery.

But is it possible to extrapolate the details likely to surround future real estate market events — and the income of brokers and their agents — by analyzing historical recession and recovery trends from the past 50 years?

Historically, all 12 Federal Bank districts which comprise the U.S. (California is located in the 12th district under the San Francisco Federal Reserve Bank) have tended to exit a recession with greater uniformity of timing than when they entered it.

The dates of each district's entry into the **Great Recession** are widely divergent, spanning from the second quarter of 2007 (Atlanta) to the first quarter of 2009 (Dallas).

Some districts routinely experience longer and deeper recessions while other districts consistently rebound faster and stronger when compared to the national average.

During deep recessions, similar to the one California is now experiencing, each district tends to recover along a similar timeline since deep recessions are remedied with federal policy, filtering to each district at roughly the same time and triggering concurrent recovery.

Thus, it can be anticipated that California will pull out of the real estate recession at about the same time Nevada, Arizona, Georgia and Florida pull out.

**Regional exceptions**

This recession has some unorthodox characteristics which belie the universal national recovery hypothesis. In the San Francisco district, which covers all of the west coast, a primary cause of the contraction came from the 2002-2005 hyper-explosion of the real estate market and the following bust.

Traditionally, districts whose recessions are triggered primarily by real estate fluctuations take longer to rebound when compared to national recovery rates, as occurred in 1974, 1981 and 1991 in California, as concluded in a recent study entitled *Recession and Recovery Across the Nation: Lessons from History* written by Chad R. Wilkerson with the Federal Reserve Bank of Kansas (FRBK).

As California was home to the most inflated real estate prices in the country during the *Millennium Boom*, it will accordingly experience a more painful, slower recovery in direct proportion to its unusual excess. The contrary has occurred in Texas where the real estate market has already largely returned to normal, from Fort Worth/Dallas to the Mexican border, thanks in large part to their commodity based economy.

This national recession shares multiple commonalities with other post-World War II recessions. As before, Chicago and Cleveland entered the recession earlier than the rest of the nation and experienced greater job loss. Similarly, the Kansas City and Dallas districts expanded for a longer period than the rest of the nation before joining in the recession as their markets had not become so rapidly unemployed or overheated.

**The future for California**

Some notable exceptions exist when considering the recession as felt in the California district. During this recession, the California district entered slightly earlier than the rest of the nation. Historically, it enters late.

The California district is also suffering one of the highest levels of job loss in the nation, which is uncharacteristic of previous recessions in which unemployment was proportionally lower.

In California, the brunt of job losses this time are felt in the construction industry which ballooned during the mid-2000s, then totally collapsed due to massive overbuilding, leaving little need for new single family residence (SFR) starts well into 2016.

Thus, the **Great Recession** in California is far deeper than any California recession felt since the Great Depression of the 1930s. Due to the unprecedented severity and depth of the current California recession, it is difficult to accurately predict the future by examining the past, as can be attempted with the national recession.

Thus, California is in uncharted territory. We possibly need to look no further than the 1930s for some guidance, since like the 1930s we have a financial crisis coupled with this recession and we have temporarily come to a stop, but this time with engines (read: people) warm and ready to go.